S. Hrg. 99-714, Pt. III

TAX REFORM ACT OF 1986, PART III

HEARING

BEFORE THE

COMMITTEE ON FINANCE
UNITED STATES SENATE

NINETY-NINTH CONGRESS

SECOND SESSION

FEBRUARY 4, 1986

(Miscellaneous Tax Subjects)

(Part 3 of 5 Parts)

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TAX REFORM ACT OF 1986, PART III

TUESDAY, FEBRUARY 4, 1986

U.S. Senate,
Committee on Finance,
Washington, DC.

The committee met, pursuant to notice, at 9:44 a.m., in room SD-215, Dirksen Senate Office Building, the Honorable Bob Packwood (chairman) presiding.

Present: Senators Packwood, Chafee, Heinz, Durenberger, Armstrong, Symms, Grassley, Long, Bentsen, Moynihan, Baucus, Bradley, and Pryor.

[The press release announcing the hearing and the prepared statement of Senator Alfonse D'Amato of New York follows:]

[Press Release No. 86-001, Monday, January 6, 1986]

Committee on Finance Sets Hearing on Tax Reform

Five days of hearings on H.R. 3838, the Tax Reform Act of 1986, have been scheduled for the first two weeks of the second session of the 99th Congress, Chairman Bob Packwood (R-Oregon) announced today.

Senator Packwood said the hearings are set for January 29 and 30, and February 4, 5, and 6.

The principal purpose of the hearings is to examine the economic effects of H.R. 3838, on international competitiveness and capital formation. Senator Packwood said the committee would invite several prominent economists to testify on this topic.

The hearings also will cover certain new subjects included in H.R. 3838, but not proposed by the Reagan Administration last year. Public witnesses will be scheduled to testify on these matters, Senator Packwood said. Senator Packwood chaired 23 hearings addressing tax reform issues between May 9 and October 10, 1985, receiving testimony from over 300 witnesses. He indicated these 1986 hearings would not cover subjects addressed at the 1985 hearings. Public witnesses will be strictly limited.

All of the hearings will begin at 9:30 a.m. in room SD-215 of the Dirksen Senate Office Building in Washington, with Senator Packwood presiding.

Alfonse D'Amato

STATEMENT BY SENATOR ALFONSE D'AMATO
SENATE FINANCE COMMITTEE
FEBRUARY 4, 1986

MR. CHAIRMAN, I THANK YOU FOR PERMITTING ME TO SUBMIT TESTIMONY TO YOUR COMMITTEE ON SECTION 1012 OF H. R. 3838, THE "TAX REFORM ACT OF 1985." I AM PARTICULARLY ALARMED OVER THE PROPOSED TAXATION OF PENSION PLAN FUNDS HELD BY TEACHERS INSURANCE AND ANNUITY ASSOCIATION AND COLLEGE RETIREMENT EQUITIES FUND (TIAA/CREF).

TIAA WAS ESTABLISHED IN 1918 TO AID HIGHER EDUCATION BY PROVIDING A PENSION SYSTEM TO REPLACE THE FREE COLLEGE RETIREMENT PENSIONS FUNDED BY ANDREW CARNEGIE. IN 1952, CREF WAS ESTABLISHED TO SUPPLEMENT TIAA COLLEGE PENSIONS THROUGH THE INTRODUCTION OF THE FIRST VARIABLE RETIREMENT ANNUITY.

TODAY, TIAA/CREF IS THE NATIONWIDE PENSION FUND FOR MORE THAN 3,600 COLLEGES, UNIVERSITIES, INDEPENDENT SCHOOLS, AND RELATED NONPROFIT EDUCATIONAL ORGANIZATIONS LOCATED THROUGHOUT THE UNITED STATES. APPROXIMATELY 83% OF THE FACULTIES EMPLOYED AT PRIVATE COLLEGES AND UNIVERSITIES AND ABOUT 50% OF FACULTIES EMPLOYED AT STATE COLLEGES AND

UNIVERSITIES ARE COVERED BY TIAA/CREF. IN MY STATE OF NEW YORK, THIS INCLUDES THE STATE UNIVERSITY OF NEW YORK AND THE CITY UNIVERSITY OF NEW YORK. I HAVE INCLUDED AT THE END OF MY STATEMENT A LIST OF PARTICIPATING INSTITUTIONS LOCATED IN NEW YORK STATE; AS YOU CAN SEE, MORE THAN 500 EDUCATIONAL ORGANIZATIONS AND MORE THAN 82,000 NEW YORKERS PARTICIPATE IN TIAA/CREF.

THE INTERNAL REVENUE SERVICE HAS DETERMINED THAT BOTH TIAA AND CREF ARE ENTITLED TO AN EXEMPTION FROM FEDERAL INCOME TAXES AS THEY ARE ORGANIZED AND OPERATED EXCLUSIVELY FOR EDUCATIONAL PURPOSES. THE CHARTERS OF BOTH TIAA AND CREF MAKE THEIR PROGRAMS AVAILABLE ONLY TO NONPROFIT EDUCATIONAL INSTITUTIONS. HOWEVER, H. R. 3838 SECTION 1012 PROPOSES, IN A SINGLE SWOOP, TO ELIMINATE THIS TAX-EXEMPT STATUS AND TO TREAT TIAA/CREF AS IF IT WAS A COMMERCIAL INSURANCE COMPANY. AS IF THIS HARSH TREATMENT IS NOT ENOUGH, THE AUTHORS OF THIS SECTION WOULD CONTINUE TAX EXEMPTION FOR OTHER PENSION FUNDS, AS WELL AS FOR THE PENSION ACTIVITIES OF FRATERNAL ORGANIZATIONS SUCH AS THE KNIGHTS OF COLUMBUS.

MR. CHAIRMAN, IF THIS PROVISION STANDS AS IT NOW IS, IT WILL RESULT IN SERIOUS CONSEQUENCES FOR TIAA/CREF. IT WILL TREAT TIAA/CREF AS IF IT WAS A COMMERCIAL INSURANCE COMPANY AND, THEREFORE, SUBJECT TO TAXATION. THIS IS JUST PLAIN WRONG.

I URGE MY COLLEAGUES ON THE FINANCE COMMITTEE TO EVALUATE THIS PARTICULAR SECTION OF THE TAX-REFORM BILL. I REALIZE TAX REFORM IS A HERCULEAN TASK, BUT A TASK THAT MUST BE ACCOMPLISHED WITH FAIRNESS AND EVEN-HANDEDNESS IF IT IS TO BE DONE AT ALL.

THANK YOU, MR. CHAIRMAN.

Alfonse D'Amato

TIAA/CREF
List of Participating Institutions

- Abilities, Inc.
- Academy for Educational Development
- Academy of Aeronautics
- Academy of Political Science
- Accreditation Board for Engineering and Technology
- Adelphi Academy
- Adelphi University
- Adirondack Historical Association
- African-American Institute
- AFS International/Intercultural Programs
- Agriculture Development Council
- Albany Academy
- Albany Academy for Girls
- Albany College of Pharmacy
- Albany Law School
- Albany Medical College
- Alexander Robertson School
- Alfred P. Sloan Foundation
- Alfred University
- All Soul's School
- Allendale Columbia School
- American Associated Ben-Gurion University of the Negev
- American Association of Engineering Societies
- American Ballet, School of
- American Council of Learned Societies
- American Federation of Arts
- American Foundation for the Blind
- American Friends of the Hebrew University
- American Geographical Society
- American Institute of Physics
- American Management Association
- American Museum of Natural History
- American Numismatic Society
- American Orthopsychiatric Association
- American Physical Society
- American Society for Technion
- American Society of Civil Engineers
- American Society of Mechnical Engineers
- Andrew W. Mellon Foundation
- Aquinas Institute of Rochester
- Archaelogical Institute of America
- Army Athletic Association
- Asia Society
- Associated Medical Schools of Greater New York

Associated Universities (operating Brookhaven National
  Laboratory and National Radio Astronomy Observatory
Association for Clinical Pastoral Education
Association for Computing Machinery
Association of Colleges and Universities of the
  State of New York
Baldwin League of Independent Schools
Bank Street College of Education
Bard College
Barnard College
Baruch College Student Center
Berkley-Carroll Street School
Birch-Wathen School
Bishop Ford Central Catholic High School
Boricua College
Brandeis School
Bearley School
Brooklyn Friends School
Brooklyn Hospital (affiliated with Downstate
  Medical Center
Brooklyn Law School
Browning School
Buckley Country Day School
Buffalo Seminary
Burke Rehabilitation Center, The
C.G. Jung Foundation
Cage Teen Center
Calasanctius Preparatory School
Calhoun School
Cambridge University Press
Canisius College
Capital District Library Council
Car and Lily Pforzheimer Foundation
Carnegie Corporation of New York
Cathedral School
Cathedral School of Saint Mary
Cazenovia College
Center for Governmental Research
Center for Psychosocial Studies
Chapin School
Chautaugua Institution
China Institute in America
China Medical Board of New York
Christian Brother Schools,
  All Hallows Institute
  Bergen Catholic High School
  Christian Brothers Institute
  Edmund Hall
  Iona Grammar School
  Iona School
  Power Memorial Academy
  Rice High School
  St. Joseph's Hall
Citizens Budget Commission

Citizens' Committee for Children of New York
City and Country School
City University of New York
  Bernard Baruch College
  Brooklyn College
  Central Office
  City College
  College of Staten Island
  Graduate School/University Center
  Hunter College
  John Jay College of Criminal Justice
  Lehman College
  Medgar Evers College
  Queens College
  York College
  Bronx Community College
  Hostos Community College
  Kingsborough Community College
  La Guardia Community College
  Manhattan Community College
  New York City Technical College
  Queensborough Community College
Clarkson Univeristy
Cold Spring Harbor Laboratory
Colgate-Rochester Divinity School
Colgate University
College Art Association of American
College Entrance Examination Board
Collegiate School
Columbia-Presbyterian Medical Center Fund
Columbia University
Columiba University Press
Commission on College Retirement
Committee for Economic Development
Commonwealth Fund
Cornell University (including Cornell University
  Medical College)
Council for Financial Aid to Education
Council on Foreign Relations
Council on International Educational Exchange
Council on Leaders and Specialists
Council on Religion and Internation Affairs
Council on Social Work Education
Credit Research Foundation
Culinary Institute of America
Daemen College
Dalton School
Darrow School
Day School
Deafness Research Foundation
Dominican College of Blauvelt
Dowling College
Dutchess Day School
D'Youville College

East Woods School
Eastman Dental Center
Edna McConnell Clark Foundation
Educational Opportunity Center for the State University of New York
Elizabeth Seton College
Elmira College
Elmwood-Franklin School
Emma Willard School
English-Speaking Union
Everson Museum of Art
Field Foundation
Fleming School
Ford Foundation
Fordham Preparatory School
Fordham University
Foreign Policy Association
Foundation Center
Foundation for Child Development
Foundation of SUNY at Binghamton
Freedom House
French Institute/Alliance Francaise
Friends Academy
Friends Seminary
Frontier Science & Technology Research Foundation
Fund for Peace, The
Gateway School
General Theological Seminary
Grace Church School
Greater Jamaica Development Association
Green Vale School
Greer-Woodycrest Children's Services
Hackley School
Hamilton College
Harbor Country Day School
Harley School
Hartwick College
Harvey School
Hebrew Academy of Long Beach
Hebrew Academy of Nassau County
Hebrew Academy of the Five Towns
Helen Keller International, Inc.
Henry George School of Social Science
Henry Luce Foundation
Hewitt School
Hewlett School
Hilbert College
Hobart and William Smith Colleges
Hofstra University
Hoosac School
Horace Mann-Barnard School
Horticultural Society of New York
Hospital for Special Surgery (Affiliated with Cornell

  University College of Medicine
Houghton Academy
Houghton College
Human Resources Center
Human Resources School
Institute for Community Design Analysis
Institute of International Education
Institute of Public Administration
Institute of Society, Ethics and Life Sciences
Insurance, College of
International Center for Law in Development
Internatioanl Council for Educational Development
International Human Assistance Programs
International Museum of Photograph
Iona College
IRI Research Institute
Ithaca College
Japan Society
Jesuits of Canisius College
Jesuits of Fordham
Jewish Theological Seminary of America
Joint Council on Economic Education
Josiah Macy, Jr. Foundation
Juilliard School
Just One Break
Kadimah School of Buffalo
Keuka College
Kew Forest School
Kildonan School
King's College, The
Kingsbrook Jewish Medical Center
  Kingsbrook Jewish Hospital
Kinneret Day School
Knox School
Kosciuszko Foundation
Lawrence Country Day School
Le Moyne College
Lenox School
Lexington School for the Deaf
Little Red School House
Locust Valley Library
Long Island Educational Television Council
Long Island University
Loudonville Christian School
Loyola School
Malcolm-King Harlem College Extension
Manhattan College
Manhattan School of Music
Manhattanville College
Manlius Pebble Hill School
Mannes College of Music
Margaret Woodbury Strong Museum
Maria College
Marist College

Mary Imogene Bassett Hospital (affiliated
with Columbia University)
Maryknoll School of Theology
Marymount College
Marymount Manhattan College
Marymount School
Masonic Medical Research Laboratory
Masters School
Mater Dei College
Maternity Center Association
McBurney School
McQuaid Jesuit High School
Medaille College
Medical Foundation of Buffalo
Medical Library Center of New York
Memorial Sloan-Kettering Cancer Center
Mercy College
Methodist Hospital of Brooklyn
Milbank Memorial Fund
Millbrook School
Modern Language Association of America
Mohawk-Hudson Council on Educatonal Television
Molloy College
Mount Saint Mary College
Mount St. Vincent, College of
Mount Sinai Medical Center
Mount Sinai School of Medicine
Museum of the American Indian Heye Foudation
Museums of Stonybrook
National Action Council for Minority Engineering
National Association of Educational Buyers
National Association of Hebrew Day School Administrators
National Baseball Hall of Fame and Museum
National Committee on United States-China Relations
National Foundation for Ileitis and Colitis
National Medical Fellowships
National Multiple Sclerosis Society
National Society to Prevent Blindness
Nazareth College of Rochester
Nazareth Regional High School
New Lincoln School
New Rochelle, College of
New School for Social Research
New York Academy of Medicine
New York Blood Center
New York Botanical Garden
New York College of Podiatric Medicine
New York Friends Group
New York Historical Society
New York Institute of Technology
New York Law School
New York Medical College
New York Psychoanalytic Institute
New York Public Library

New York Quarterly Meeting of the Religious Society
New York of Friends
New York School of Interior Design
New York Society Library
New York Historical Association and The
New York, State University of
  State University of New York at Albany
  State University of New York at Binghamton
  State University of New York at Buffalo
  State University of New York at Stony Brook
  Central Administration
  Downstate Medical Center
  Upsate Medical Center
  College at Brockport
  College at Buffalo
  College at Cortland
  College at Fredonia
  College at Geneseo
  College at New Paltz
  College at Old Westbury
  College Oneonta
  College at Oswego
  College at Plattsburgh
  College at Potsdam
  College at Purchase
  College of Optometry
  Maritime College
  College of Environmental Science and Forestry
  College of Ceramics at Alfred University at
    Cornell University
  College of Human Ecology at Cornell University
  College of Technology
  School of Industrial and Labor Relations at
    Cornell University
  Veterinary College at Cornell University
  Empire State College
  Agricultural and Technical College at Canton
  Agricultural and Technical College at Alfred
  Agricultural and Technical College at Cobleskill
  Agricultural and Technical College at Delhi
  Agricultural and Technical College at Farmingdale
  Agricultural and Technical College at Morrisville
New York State University of, Community Colleges
  Adirndack Community College
  Broome Community College
  Cayuga County Community College
  Clinton Community College
  Columbia-Greene Community College
  Corning Community College
  Dutchess Community College
  Erie Community College
  Fashion Institute of Technology
  Community College at the Finger Lakes
  Fulton Montgomergy Community College

- Genesee Community College
- Herkimer County Community College
- Hudson Valley Community College
- Jamestown Community College
- Jefferson Community College
- Mohawk Valley Community College
- Monroe Community College
- Nassau Community College
- Niagara County Community College
- North Country Community College
- Onondaga Community College
- Orange County Community College
- Rockland Community College
- Schenectady County Community College
- Suffolk County Community College
- Sullivan County Community College
- Tompkins-Cortland Community College
- Ulster County Community College
- Westchester Community College

New York Theological Seminary
New York University
Niagara University
Nichols School
Nightingale-Bamford School
North Country Reference and Research Resources Council
North Country School
North Shore Hebrew Academy
Northwood School
Notre Dame High School
Nyack College
Oakwood School
Onondaga Pastoral Counseling Center
Orange County Association for the Help of the
  Retarded Childred
Pace University
Packer Collegiate Institute
Palisades Geophysical Institute
Palisades Institute for Research Services
Park School of Buffalo
Parsons School of Design
Phelps-Stokes Fund
Pierpont Morgan Library
Polytechnic Institute of New York
Polytechnic Preparatory Country Day School
Population Council
Portledge School
Postgraduate Center for Mental Health
Poughkeepsie Day School
Poughkeepsie Law Institute
Practising Law Institute
Pratt Institute
Preventive Medicine Institute-Strang Clinic
Prospect Park Yeshiva
Rabbi Jacob Joseph School

Ramaz School
Recorded Anthology of American Music
Regional Plan Association
Regis High School
Rensselaer Polytechnic Institute
Rensselaerville Institute, The
Research Foundation for Mental Hygiene
Research Foundation of the City University of New York
Research Foundation of the States University of New York
Rippowam-Cisqua School
Riverside Research Institute
Roberson Center for the Arts and Sciences
Roberts Wesleyan College
Rochester Area Colleges
Rochester Area Educational Television
Rochester Industries Educational Fund
Rochester Institute of Technology
Rochester Museum and Science Center
Rochester Regional Research Library Council
Rochester, University of
Rockefeller University
Rockville Centre Public Library
Rogosin Institute
Rudolf Steiner School
Russell Sage College
Russell Sage Foundation
Rye Country Day School
Saint Anthony's High School
St. Bernard's School
St. Bonaventure University
Saint David's School
St. Francis College
St. Francis Preparatory School
St. Hilda's and St. Hugh's School
St. John Fisher College
St. John's University
St. Joseph's Collegiate Institute
St. Lawrence University
St. Lawrence Valley Educational Television Council
St. Michael's Montessori School
St. Paul's School
Saint Rose, College of
St. Thomas Aquinas College
Salina Health Education Foundation
Sara Lawrence College
Sephardic Institute High School
Siena College
Skidmore College
Social Science Research Council
Society for the Preservation of Long Island Antiquities
Society of the New York Soepital
Covent of the Sacret Heart
Doane Stuart School
Kenwood Convent of the Sacred Heart

Solomon Schechter School
South Central Research Library Council
South Street Seaport Museum
Southern Tier Educational television
Special Libraries association
Spence School
State Communities Aid Association
Staten Island Academy
Stony Brook Foundation
Stony Brook School
Storm King School
SUNY-Manhattan Education Opportunity Center
Syracuse Research Corporation
Syracuse University
Teachers College, Columbia University
Teachers Insurance and Annuity Association
Threefold Educational Foundation and School
Touro College
Touro Law School
Town School
Trilateral Commission (North America)
Trinity School
Troy Public Library
Trudeau Institute
Tuxedo Park Library
Tuxedo Park School
Twentieth Central Fund
Union College
Union Theological Seminary
United Engineering Trustees
United Nations Association
United Nations International School
United Negro College Fund
United States Committee for Unicef
University at Buffalo Foundation
Utica College of Syracuse University
Villa Maria College of Buffalo
W. Alton Jone Cell Science Center
Wagner College
Walden School
Waynflete school
WCNY TV/FM
Webb Institute of Naval Architecture
Wells College
Wenner-Gren Foundation for Anthropological Research
West Side Montessori School
Westbury Friends School
Western New York Public Broadcasting Association
William Alanson White Institute
William T. Grant Foundation
Woodmere Academy
Woodward Park School
Wold Policy Institute
Xaverian High School

Yeshiva of Forest Hills
Yeshiva Tifereth Moshe

Senator PACKWOOD. The hearing will come to order, please.

This is a continuation of a series of hearings on the tax reform bill. We have heard from some economists before. We will have some more later this week. Yesterday, we heard from four certified public accountants on the issue of the minimum tax because the House-passed minimum tax was so significantly different than the administration's proposal or the way we considered it. Today we have a potpourri of different subjects that were not heard in our 33 days of hearings last summer.

Senator Long and I, at about 11 o'clock, will have to leave and go to the Rules Committee where we are presenting the budget for the Finance Committee for next year, but, hopefully, we will not be delayed long.

Our first witness today is the Honorable Pete Wilson, the Senator from California. Senator.

STATEMENT OF HON. PETE WILSON, A U.S. SENATOR FROM THE STATE OF CALIFORNIA

Senator WILSON. Thank you very much, Mr. Chairman. I am particularly grateful to the committee for this opportunity to address you. I have appeared before on the subject of tax-exempt financing with respect to the economic and capital viability of our States and localities.

This morning I am addressing a specific aspect of tax-exempt financing, that which has been called tax increment or at times called tax allocation bond financing.

Mr. Chairman, tax increment financing has enabled communities throughout the Nation to responsibly help themselves eliminate blight and to bring about needed redevelopment. It is a critically important tool. And it is no exaggeration to say that without it, redevelopment simply will be unable to occur in the 35 States that have adopted it.

It is assuming a particular importance and even greater importance than in the past as cities now come to the time of reckoning when they can no longer depend upon Federal grants to help meet their redevelopment or community development needs.

So to eliminate blight and to redevelop their cities, some 35 States throughout America have chosen this method of financing. The bonds that are issued for public land assembly are absolutely essential. The bonds are redeemed by property taxes derived under State law from the increment of increased assessed valuation of the property after its redevelopment. The new property taxes flowing from redevelopment are allocated by State law to the retirement of the bonds, and it is only after the retirement of the bonds that these new revenues become available for general local governmental purposes.

In short, redevelopment financed by tax increment creates new value where slums stood, new local revenues and new jobs which produce new State and, not at all parenthetical, new Federal revenues, new Federal income taxes.

None of these benefits, Mr. Chairman, would be created without redevelopment and redevelopment would not take place without tax increment financing, not in California nor in any of the 35

States which have chosen tax increment financing as their method of funding public reclamation of blighted neighborhoods.

Now bear in mind, if you will, that tax increment financing means improving an area using the increased local tax base and revenues resulting from redevelopment. Local taxes repay tax increment bonds, not State or Federal moneys. The sole Federal participation in the process of State redevelopment is the redemption of interest paid to bond holders from Federal income taxation. That is the only Federal participation.

Eliminating or severely restricting the tax-exempt status of tax increment bonds as H.R. 3838 proposes would be shortsighted in the extreme. Particularly when the Joint Economic Committee recently identified capital financing needs nationwide of $1.1 trillion through the year 2000, or expressed annually, the requirement for $73 billion for the extension and renewal of America's vital infrastructure, much of which can be achieved through State redevelopment even unaided by Federal community development grant funds formerly available.

But it cannot be achieved, Mr. Chairman, if the tool chosen by cities all across the Nation, to transform their downtowns and neighborhoods from blighted drains on municipals budgets to viable communities, is now denied them, as H.R. 3838 proposes in its most unwise constraints upon tax increment financing.

Over the last 5 years Federal funding for redevelopment has dropped 40 percent before Gramm-Rudman-Hollings. Reforms and deficit reduction efforts are obviously essential. No one has been louder, more vocal than I. But we must be very clear in our own minds that reforms inspired by good intentions do not unjustly and unwisely impair the ability of State and local governments to meet their responsibilities.

At the same time that State and local governments are being asked to shoulder greater burdens and greater costs, Congress must not eliminate the very tools that these entities have relied upon to finance their traditional responsibilities.

Mr. Chairman, I know first-hand the importance and the success possible from tax increment financing. About 10 years ago—well, more than that—San Diego undertook an ambitious plan to turn around a genuinely blighted downtown, one that was littered with tattoo parlors, adult bookstores, peep shows, nonproductive uses that were a physical and social blight upon the landscape. The taxes generated from the area at that time did not begin to cover the cost of the public services extended to them.

Thanks to tax increment revenues, today downtown San Diego is the home of new office towers and hotels, a major retail center employing thousands, an emerging residential neighborhood improvements which have, in turn, spurred ongoing, extensive private restoration all around it, including an abutting historic district. Several thousand jobs have been created. Fully, a quarter of these were filled by formerly unemployed persons.

Mr. Chairman, I can tell you categorically that this redevelopment would never have occurred without tax increment bonds. Tax increment financing allowed San Diego to help itself to meet its individual needs. Alternative financing was not available then because, very candidly, although it has now spurred private efforts, no one was willing to be the bold and lonely pioneer in investing in a blighted area surrounding by blight and putting good investment into that kind of a climate.

Now given the obvious benefits made possible only by tax increment financed redevelopment, what justification is there for removing Federal income tax-exempt status that makes it all possible? Revenue enhancement?

Mr. Chairman, tax increment bonds make up less than 1 percent of all tax-exempt bonds issued nationwide. Therefore, while the projected revenues generated with the tax-exempt bond provisions in H.R. 3838 are less than $3 billion through the fiscal years 1987 through 1990, tax increment financed redevelopment can be expected to generate some $30 million in new Federal revenues during those 4 years.

No, Mr. Chairman, there would seem to be at best a wash and no real revenue enhancement to justify elimination of tax-exempt increment bonds. But, in fact, there is a far more important policy reason than simple revenue enhancement or its absence.

In fact, elimination of the exemption could kill substantial other savings to the Federal Government achieved by the use of tax increment bonds to redevelop blighted areas.

In Los Angeles, the Bunker Hill redevelopment transformed a $100 million tax base in 1959 to more than $2 billion today. It also brought thousands and thousands of new jobs. The economic loss caused by H.R. 3838's stifling of redevelopment will exceed the savings generated by limiting tax increment financing. Ask any local official charged with responsibility for economic development. Jobs come to redeveloped areas and jobs flee from blighted areas. You find welfare offices in slums doing the heavy business, not the employment offices.

H.R. 3838 classifies tax increment bonds as nonessential function bonds subject to a cap and other stringent restrictions.

Mr. Chairman, who says that slum clearance and the replacement of physical and social blight with new value, new revenues and new jobs is a nonessential function? Redevelopment bonds are public purpose bonds which merit tax exemption every bit as much as other bonds backed by State and local taxes.

How in the world could the same administration that has enthusiastically endorsed tax breaks to rehabilitate urban enterprise zones now seek with the other hand to take away the traditional tool of tax exemption from a traditional responsibility of local government redevelopment?

Budget deficits have required reductions in Federal funds to cities and new federalism has brought shifting roles. As our localities now assume, as a result, the almost exclusive responsibility for the Nation's overwhelming infrastructure and redevelopment needs, it is ironic—no, inconceivable—that Congress would at the same time, by H.R. 3838, eliminate or effectively gut the most effective and viable financing tool available to State and local government. To do so would be a pernicious idea, whatever good intentions may have inspired it, and a grave error which would be memorialized in the unaddressed decay of America's cities.

Mr. Chairman, I implore you and the committee to reject this bad idea. Thank you.

The **Chairman**. Thank you, Senator.

According to the early bird list I have, it is in the following order: Heinz, Danforth, Baucus, Long, Packwood, Grassley, Chafee, Bentsen, and Durenberger. Senator Heinz.

Senator **Heinz**. No questions, Mr. Chairman.

The **Chairman**. Senator Danforth is gone. Senator Baucus.

Senator **Baucus**. Thank you, Mr. Chairman.

Senator Wilson, I think you made a very good statement. I hear many of the same concerns in my home in Montana, I thank you very much for your statement. I know that it will be quite well received on the committee. I thank you very much.

Senator **Wilson**. Thank you, sir.

The **Chairman**. I have no questions. Senator Grassley.

Senator **Grassley**. I don't have a question, but I would like to say for the benefit of the committee that Iowa was 1 of maybe 8—somewhere between 8 and 13 States that make a great deal of use of the type of bonding that Senator Wilson refers to. And I don't know to what extent there are possibilities for compromise as opposed to going as far as the committee—House Ways and Means Committee did, and I don't know to what extent we should even be talking about compromise in this area, but I would hope that we would try to retain some of the benefits that come from this form of financing because it has been used very well in my State to accomplish a lot of the goals that Senator Wilson refers to.

The **Chairman**. Senator Chafee.

Senator **Chafee**. Well, I just want to thank Senator Wilson for that very powerful statement. It sets it forth very well. And I want to express our appreciation for you taking the trouble to be here today.

The **Chairman**. Senator Bentsen.

Senator **Bentsen**. Only to reflect again, reiterate rather, what Senator Chafee said. It is a problem we all share and you made a good statement. I appreciate it.

The **Chairman**. Senator Durenberger.

Senator **Durenberger**. Pete, we spent a lot of time on this committee last year and the year before, I think, and maybe even the year before that, on enterprise zones and all kinds of wonderful administration solutions to the problem of redevelopment of our communities. And it always struck me while we were debating that that we had in hand a tool that was already doing a pretty good job in States like California, Minnesota, Iowa, and others in tax increment financing.

Since the House did its job on tax exempts, I have noticed there is a fair amount of confusion out there about the relationship between various kinds of exempt bonds and confusion between general obligation bonds, and revenue bonds and so forth. But, in particular, there seems to be a mixup in people's understanding about the differences between the tax exempt, or the TIF, tax increment financing, arrangements that you testified to and IDB's, the industrial development bond.

I wonder if you might make clear for the other members of the committee or the record what the difference or the distinction is.

Senator **Wilson**. Senator Durenberger, there are several distinctions. First, the industrial development bond can be used to finance private business ventures, whereas, tax increment financing is available only to a public redevelopment agency and only for the specific purpose of assembling land that is to be redeveloped. It can qualify under almost all of these 35 State laws only if the land in question qualifies for the legal term "blight." That is not a poetic term. It is a legal term of art. And without a verbatim definition, it involves the physical deterioration of the area affected to the point where it is not paying its fair share of property taxes and where it is in fact generating problems of a social nature as well.

With respect to repayment, the IDB's are repaid from private sources. They often involve no commitment of public funds. A public agency is involved as the technical issuer. In contrast, tax increment is repaid by local property taxes derived from the local property tax base. And it is a simple but ingenious idea. The redevelopment creates new values. The new value is earmarked for the redemption of the bonds. But the only Federal participation here obviously is in terms of the exemption to make the bonds attractive on the market.

There are other distinctions that relate to the limits, tax increment, because it is only repayable through local taxes or limited obviously by the availability of local taxes, and by the local willingness to commit those dollars under the choice given to the local agency by State law.

But, in effect, there is a guarantee because of State law and the decision taken by a local government to create a redevelopment agency.

But essentially they are for different purposes, even though both generate employment.

Senator DURENBERGER. Mr. Chairman, I trust we will take our colleague's advice in the drafting of the Senate Finance Committee version.

The CHAIRMAN. I think we will take all of our colleagues' advice on everything. Thank you very much, Senator. We appreciate it.

Senator WILSON. Thank you, Mr. Chairman.

The CHAIRMAN. Our next witness is Congressman Frenzel. Is he here? He is on his way. He is a little late. Let's move on to the next panel then. I don't know how long he will be. And let's take a panel of Mr. Bernard Tresnowski and James MacDonald. If Congressman Frenzel comes, I will interrupt you just momentarily and put him on.

[The prepared written statement of Senator Wilson follows:]

TESTIMONY BY SENATOR PETE WILSON

BEFORE THE COMMITTEE ON FINANCE

UNITED STATES SENATE

REGARDING TAX INCREMENT FINANCING

FEBRUARY 4, 1986
SD-215

MR. CHAIRMAN, I APPRECIATE THE OPPORTUNITY TO APPEAR BEFORE YOUR COMMITTEE TODAY. ALTHOUGH I HAVE PREVIOUSLY SUBMITTED TESTIMONY REGARDING THE IMPORTANCE OF TAX-EXEMPT FINANCING TO THE ECONOMIC AND CAPITAL VIABILITY OF STATES AND LOCALITIES, THE GRAVITY OF THE SITUATION COMPELS ME TO TESTIFY AGAIN.

H.R. 3838 THREATENS TO CRIPPLE A MOST IMPORTANT REDEVELOPMENT TOOL: TAX INCREMENT FINANCING. THIS MORNING I WANT TO DISCUSS THE SIGNIFICANCE OF TAX INCREMENT FINANCING -- A PERSPECTIVE THAT STEMS IN PART FROM MY EXPERIENCE AS MAYOR OF SAN DIEGO AND AS PRESIDENT OF THE LEAGUE OF CALIFORNIA CITIES.

MR. CHAIRMAN, TAX INCREMENT FINANCING ENABLES COMMUNITIES THROUGHOUT THE COUNTRY TO RESPONSIBLY HELP THEMSELVES ELIMINATE BLIGHT AND FOSTER REDEVELOPMENT. THIS FINANCING TOOL ASSUMES EVEN GREATER IMPORTANCE TO LOCALITIES BECAUSE THEY CAN NO LONGER DEPEND ON FEDERAL GRANTS TO HELP MEET THEIR REDEVELOPMENT NEEDS. TO ELIMINATE BLIGHT AND REDEVELOP THEIR CITIES, THIRTY-FIVE STATES HAVE AUTHORIZED PUBLIC LAND ASSEMBLY FINANCED BY ISSUANCE OF TAX INCREMENT OR TAX ALLOCATION BONDS. THE BONDS ARE REDEEMED BY PROPERTY TAXES DERIVED FROM THE INCREMENT OF INCREASED ASSESSED VALUATION OF THE PROPERTY AFTER REDEVELOPMENT. THE "NEW" PROPERTY TAXES FLOWING FROM REDEVELOPMENT ARE ALLOCATED BY STATE LAW TO RETIREMENT OF THE BONDS, AFTER WHICH THEY ARE AVAILABLE FOR GENERAL LOCAL GOVERNMENTAL PURPOSES.

IN SHORT, REDEVELOPMENT FINANCED BY TAX INCREMENT CREATES NEW VALUE WHERE SLUMS STOOD, NEW LOCAL REVENUES AND NEW JOBS WHICH PRODUCE NEW STATE AND FEDERAL REVENUES. NONE OF THESE BENEFITS WOULD BE CREATED WITHOUT REDEVELOPMENT AND REDEVELOPMENT WOULD NOT TAKE PLACE WITHOUT TAX INCREMENT FINANCING NOT IN CALIFORNIA, NOR ANY OF THE 35 STATES WHICH HAVE CHOSEN TAX INCREMENT FINANCING AS ITS METHOD OF FUNDING PUBLIC RECLAMATION OF BLIGHTED NEIGHBORHOODS.

REMEMBER, TAX INCREMENT FINANCING MEANS IMPROVING AN AREA USING THE INCREASED LOCAL TAX BASE AND REVENUES RESULTING FROM REDEVELOPMENT. LOCAL TAXES REPAY TAX INCREMENT BONDS, NOT STATE OR FEDERAL MONIES. THE SOLE FEDERAL PARTICIPATION IN THE PROCESS OF STATE REDEVELOPMENT IS THE EXEMPTION OF INTEREST PAID TO BOND HOLDERS FROM FEDERAL INCOME TAXATION.

ELIMINATING OR SEVERELY RESTRICTING THE TAX-EXEMPT STATUS OF TAX INCREMENT BONDS AS H.R. 3838 PROPOSES WOULD BE SHORT-SIGHTED IN THE EXTREME. PARTICULARLY WHEN THE JOINT ECONOMIC COMMITTEE RECENTLY IDENTIFIED CAPITAL FINANCING NEEDS NATION-WIDE OF $1.1 TRILLION THROUGH THE YEAR 2000, OR $73 BILLION ANNUALLY FOR THE EXTENSION AND RENEWAL OF AMERICA'S VITAL INFRASTRUCTURE -- MUCH OF WHICH CAN BE ACHIEVED THROUGH STATE REDEVELOPMENT EVEN UNAIDED BY FEDERAL COMMUNITY DEVELOPMENT GRANT FUNDS FORMERLY AVAILABLE.

BUT IT CANNOT BE ACHIEVED, MR. CHAIRMAN, IF THE TOOL CHOSEN BY CITIES ALL ACROSS THE NATION, TO TRANSFORM THEIR DOWNTOWNS AND NEIGHBORHOODS FROM BLIGHTED DRAINS ON CIVIC BUDGETS TO VIABLE COMMUNITIES, IS NOW DENIED THEM AS HR 3838 PROPOSES IN ITS MOST UNWISE CONSTRAINTS UPON TAX INCREMENT FINANCING.

OVER THE LAST FIVE YEARS FEDERAL FUNDING FOR REDEVELOPMENT HAS DROPPED 40% IN NOMINAL DOLLARS -- BEFORE GRAMM-RUDMAN-HOLLINGS. REFORMS AND DEFICIT REDUCTION EFFORTS ARE ESSENTIAL, HOWEVER, OUR WELL INTENDED "REFORMS" MUST NOT UNJUSTLY IMPAIR THE ABILITY OF STATE AND LOCALITIES TO MEET THEIR RESPONSIBILITIES.

AT THE SAME TIME THAT STATE AND LOCAL GOVERNMENTS ARE BEING ASKED TO SHOULDER GREATER BURDENS AND COSTS, CONGRESS MUST NOT ELIMINATE THE VERY TOOLS THESE ENTITIES HAVE RELIED UPON TO FINANCE THEIR TRADITIONAL RESPONSIBILITIES.

MR. CHAIRMAN, I KNOW FIRST-HAND THE IMPORTANCE AND SUCCESS OF TAX INCREMENT FINANCING. ABOUT 10 YEARS AGO SAN DIEGO UNDERTOOK AN AMBITIOUS PLAN TO TURNAROUND ITS DOWNTOWN WHICH WAS LITTERED WITH TATTOO PARLORS, ADULT BOOK STORES, PEEP SHOWS AND THE LIKE. THE TAXES GENERATED FROM THE AREA DIDN'T COVER THE COST OF PUBLIC SERVICES.

THANKS TO TAX INCREMENT REVENUES, TODAY DOWNTOWN SAN DIEGO IS THE HOME OF NEW OFFICE TOWERS AND HOTELS, A MAJOR RETAIL CENTER, AN EMERGING RESIDENTIAL NEIGHBORHOOD IMPROVEMENTS WHICH HAVE IN TURN SPURRED ON-GOING, EXTENSIVE PRIVATE RESTORATION OF AN ABUTTING HISTORIC DISTRICT. SEVERAL THOUSAND JOBS HAVE BEEN CREATED -- 25 PERCENT OF THESE WERE FILLED BY FORMERLY UNEMPLOYED PERSONS.

MR. CHAIRMAN, I CAN TELL YOU CATEGORICALLY THAT THIS REDEVELOPMENT WOULD NEVER HAVE HAPPENED WITHOUT TAX INCREMENT BONDS. TAX INCREMENT FINANCING ALLOWED SAN DIEGO TO HELP ITSELF AND TO MEET ITS INDIVIDUAL NEEDS. ALTERNATIVE FINANCING WAS NOT AVAILABLE THEN AND TODAY'S BUDGET DEFICITS MAKE ALTERNATIVES VIRTUALLY NON-EXISTENT.

GIVEN THE OBVIOUS BENEFITS MADE POSSIBLE ONLY BY TAX INCREMENT FINANCED REDEVELOPMENT, WHAT JUSTIFICATION IS THERE FOR REMOVING THE FEDERAL INCOME TAX EXEMPT STATUS THAT MAKES IT ALL POSSIBLE? REVENUE ENHANCEMENT?

MR. CHAIRMAN, TAX INCREMENT BONDS MAKE UP LESS THAN ONE PERCENT OF ALL TAX EXEMPT BONDS ISSUED NATIONWIDE. THEREFORE, WHILE THE PROJECTED REVENUES GENERATED WITH THE TAX EXEMPT BOND PROVISIONS IN H.R. 3838 ARE LESS THAN $3 BILLION FROM FY 87-90, TAX INCREMENT FINANCED REDEVELOPMENT CAN BE EXPECTED TO GENERATE LESS THAN $30 MILLION IN NEW FEDERAL REVENUES DURING THOSE FOUR YEARS. NO, MR. CHAIRMAN, THERE WOULD SEEM TO BE AT BEST A WASH AND NO REAL REVENUE ENHANCEMENT TO JUSTIFY ELIMINATION OF TAX EXEMPT TAX INCREMENT BONDS.

BUT IN FACT ELIMINATION OF THE EXEMPTION COULD KILL SUBSTANTIAL OTHER SAVINGS TO THE FEDERAL GOVERNMENT ACHIEVED BY THE USE OF TAX INCREMENT BONDS TO REDEVELOP BLIGHTED AREAS. IN LOS ANGELES, THE BUNKER HILL REDEVELOPMENT TRANSFORMED A $100 MILLION TAX BASE IN 1959 TO A MORE THAN $2 BILLION TAX BASE TODAY. IT ALSO BROUGHT THOUSANDS OF NEW JOBS. THE ECONOMIC LOSS CAUSED BY H.R. 3838'S STIFLING OF REDEVELOPMENT WILL EXCEED THE SAVINGS GENERATED BY LIMITING TAX INCREMENT FINANCING. ASK ANY LOCAL OFFICIAL CHARGED WITH ECONOMIC DEVELOPMENT: JOBS COME TO REDEVELOPED AREAS AND JOBS FLEE FROM BLIGHTED AREAS. YOU FIND WELFARE OFFICES IN SLUMS DOING HEAVY BUSINESS, NOT EMPLOYMENT OFFICES.

H.R. 3838 CLASSIFIES TAX INCREMENT BONDS AS "NONESSENTIAL FUNCTION" BONDS SUBJECT TO A CAP AND OTHER STRINGENT RESTRICTIONS. WHO SAYS THAT SLUM CLEARANCE AND THE REPLACEMENT OF PHYSICAL AND SOCIAL BLIGHT WITH NEW VALUE, NEW REVENUES, AND NEW JOBS IS A "NON-ESSENTIAL FUNCTION?" REDEVELOPMENT BONDS ARE PUBLIC PURPOSE BONDS WHICH MERIT TAX EXEMPTION EVERY BIT AS MUCH AS OTHER BONDS BACKED BY STATE AND LOCAL TAXES.

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HOW IN THE WORLD COULD THE SAME ADMINISTRATION THAT HAS ENTHUSIASTICALLY ENDORSED TAX BREAKS TO REHABILITATE "URBAN ENTERPRISE ZONES" NOW SEEK WITH THE OTHER HAND TO TAKE AWAY THE TRADITIONAL TOOL OF TAX EXEMPTION FROM REDEVELOPMENT?

BUDGET DEFICITS HAVE REQUIRED REDUCTIONS IN FEDERAL FUNDS TO CITIES AND NEW FEDERALISM HAS BROUGHT SHIFTING ROLES. AS OUR LOCALITIES NOW ASSUME AS A RESULT THE ALMOST EXCLUSIVE RESPONSIBILITY FOR THE NATION'S OVERWHELMING INFRASTRUCTURE AND REDEVELOPMENT NEEDS, IT IS IRONIC -- NO, INCONCEIVABLE -- THAT CONGRESS WOULD AT THE SAME TIME BY H.R. 3838 ELIMINATE OR EFFECTIVELY "GUT" THE MOST EFFECTIVE AND VIABLE FINANCING TOOL AVAILABLE TO STATE AND LOCAL GOVERNMENT. TO DO SO WOULD BE A PERNICIOUS IDEA, WHATEVER GOOD INTENTIONS MAY HAVE INSPIRED IT, AND A GRAVE ERROR WHICH WOULD BE MEMORIALIZED IN THE UNADDRESSED DECAY OF AMERICA'S CITIES.

STATEMENT OF BERNARD R. TRESNOWSKI, PRESIDENT, BLUE CROSS AND BLUE SHIELD ASSOCIATION, CHICAGO, IL

Mr. TRESNOWSKI. Thank you very much, Mr. Chairman, and members of the committee.

I appreciate the opportunity to appear before you on behalf of the nearly 80 million Americans who receive their health coverage from Blue Cross and Blue Shield plans.

What I want to focus on today are the special needs of 11 million people covered by our plans as individuals and many more of those in small groups. Many of these people are high health risks and cannot secure adequate, affordable health coverage from any other source.

Since our plans were founded by people with vision, courage, and determination in communities all across our land, they have continued to provide comprehensive affordable health coverage on a nonprofit private sector basis to the most vulnerable of our citizens: the sick, the elderly, members of small employer groups and individuals with no group affiliation.

The unique business practices followed by our Blue Cross and Blue Shield plans include, first, returning a much higher percentage of premium payments to individual subscribers in the form of benefits than do commercial insurers. We return an average of 88 cents of every premium dollar compared to 54 cents by commercial companies.

Next, offering individual coverage. By definition, individual subscribers represent higher risks than group members, and this is one of the reasons that a number of major insurance companies have stopped offering individual coverage.

Third, guaranteeing persons leaving a group and their family members the right to convert to affordable individual coverage;

Next, continuing to provide small group coverage to employees and their families. We have remained in the small group market even as commercial insurers have come and gone.

And, finally, setting the standards for communitywide cost containment, engaging in practices that benefit not just our own operations, but the entire community as well as our competitors.

That the Blue Cross and Blue Shield plans have been able to continue these practices and remain competitive in the marketplace is a tribute to a very delicate balance developed over half a century. This balance has been maintained despite the introduction of experience rating by commercial insurers. This balance has been maintained despite the provision in the ERISA Act which allows self-funded groups to be exempt from the growing list of State requirements.

This balance has been maintained through the aggressive pursuit of cost containment, and the tax exemption itself. When combined, these two factors allow our plans to achieve that delicate balance between income and expense while providing coverage to millions of high risk individuals.

That balance is now in jeopardy because of the tax bill passed by the House. That bill singles out Blue Cross and Blue Shield plans while continuing the exemption from tax of HMO's and self-funded plans which are the fastest growing segments of the health insurance market.

The further advantage to competitors who continue to avoid high risk, high cost individuals and small groups will put even greater pressure on the Blue Cross and Blue Shield plans and their current business practices.

For Blue Cross and Blue Shield plans to remain competitive while covering the new cost of taxation would require an increase in small group and individual rates. And when this occurs, lower risk individuals will be inclined to seek coverage elsewhere, forcing premiums for those who are left—primarily high risk individuals—even higher.

As the spiral of increased risk and costs combined with the reduced subscriber base accelerates, the bottomline is clear. Many individuals and small group members, those who need our coverage most, would be priced out of the market and plans would be forced to change their enrollment practices to limit access to coverage.

Not only will the delicate balance be lost but the Federal Government would be a major loser as the disproportionately high cost of health care for hundreds of high risk individuals, unable to afford a secure coverage from our plans, moves to the public sector.

The results of ending our tax exempt status are clear. The dollar cost to the Government will be greater than the revenue gained. The social cost of forcing proud, independent people to seek Federal assistance would be devastating. The entire proposition runs contrary to national policy goals of private sector initiative and reduced Federal spending.

The Nation's Blue Cross and Blue Shield plans are unique; they work. For the Congress to turn its back on that record of performance would be a tragedy of enormous proportion.

Clearly, there is no rational reason to tamper with the ability of Blue Cross and Blue Shield plans to serve communities across America, nor with the right of millions of Americans to secure affordable quality health coverage through the private sector.

Thank you very much, Mr. Chairman.

[The prepared written statement of Mr. Tresnowski follows:]

TESTIMONY OF BERNARD R. TRESNOWSKI

PRESIDENT, BLUE CROSS AND BLUE SHIELD ASSOCIATION

SENATE COMMITTEE ON FINANCE

FEBRUARY 4, 1986

Mr. Chairman, Members of the Committee. I appreciate the opportunity to appear before you today on behalf of the nearly 80 million Blue Cross and Blue Shield Plan subscribers throughout the country.

The deliberations of the Committee can have a direct impact on the affordability and quality of the health care coverage of millions of our subscribers -- particularly those who are not members of large employer groups.

As you know, the 85 Blue Cross and Blue Shield Plans are non-profit, community-based organizations that have been exempt from federal tax for important public policy reasons since their creation in the 1930's.

These community-based Plans continue to earn that tax exemption every day by providing comprehensive, affordable health care on a non-profit basis to the most vulnerable of our citizens -- the sick, the elderly, members of small employer groups and individuals who have no group affiliation.

Now the tax exemption is threatened. For reasons that we and our subscribers find difficult to understand, the House voted to remove the half-century-old tax exemption.

It is important to note that the removal of the Plans' tax exemption was not included in the President's tax reform recommendation nor was it included in either of the two major Congressional tax initiatives.

There was no opportunity for hearings or detailed analysis of the impact that removal of our tax exemption would have on the health care delivery system or on the ultimate cost to the government. The provision was approved by the committee on a voice vote and there was no opportunity for the full House to review it.

It is now up to the Senate to examine the impact. We believe it will rapidly become clear that:

- the dollar cost to the government of removing the exemption would be greater than the revenue gained,
- the social cost of forcing proud, independent people to seek federal assistance for their health care would be incalculable, and
- this threat to a truly remarkable private sector program embodied in the Blue Cross and Blue Shield system runs contrary to the national policy goals of private sector initiative and reducing federal spending.

I believe that taxing the Plans would be destructive to our organization's purpose of meeting the needs of the communities we serve. The Plans' ability to assure access to affordable, quality health care coverage -- the keystone of the Blue Cross and Blue Shield concept -- would be severely limited.

In short, the added financial burden placed on the Plans through the House bill would be a tax on the people we serve, and would fall the most heavily on the people who need adequate health coverage the most.

Rates would have to be increased, and our ability to cover the highest risks and provide other unique services that meet our communities' needs would be seriously diminished.

We would be left with a situation where the need for the Blue Cross and Blue Shield concept would remain, but it would be impossible to reinvent it within the private sector. This time the burden would fall on the government.

Founding of Blue Cross and Blue Shield

To understand the role of our organization, we should briefly review how and why Blue Cross and Blue Shield Plans developed as one of the private sector's most successful health programs.

The worldwide depression of the 1930s exacerbated an already serious lack of access to adequate health care services. The response throughout much of the rest of the world was the development of national health care delivery or national health insurance programs, turning health care financing into a function of the national government.

In the United States, we took a different approach -- a private sector approach.

Beginning in 1929, non-profit community-based organizations were created by a cross section of local leadership -- first in Texas, but quickly in the other states -- to sign contracts with hospitals for the provision of hospital care in return for payment of a periodic fee. These hospital care organizations became known as the Blue Cross Plans.

Blue Shield Plans -- similar non-profit community-based organizations formed to provide physicians' services -- soon followed and the concept rapidly spread throughout the country.

The Blue Cross and Blue Shield concept truly was revolutionary. The Plans proved that pre-paid health care coverage could be provided at affordable rates to the vast majority of American consumers.

Importantly, the Plans proved that such coverage could be provided in a private sector context, independent of the government.

In recognition of the fact that the Plans were operated on a non-profit basis providing important services to their communities, they were judged by the Internal Revenue Service to be exempt from federal taxation under section 501(c)(4) of the Internal Revenue Code. Since the 1930's the IRS has consistently recognized the tax exempt status of the Blue Cross and Blue Shield Plans.

Commercial Insurers Enter the Market

The Blue Cross and Blue Shield Plans invented the concept now known as health insurance. Seeing that it worked, commercial insurance companies were quick to follow the lead. By 1963, more than 900 insurance companies were actively writing health insurance.

There has always been an important difference between the Blue Cross and Blue Shield Plans and the commercial insurers, however. That difference is one of purpose and philosophy underscored by day-to-day operating practices. The Plans have a strong obligation to their communities, as well as to their subscribers, and discharge those community obligations in ways that do not add to the "bottom line." Commercial insurers do not share those community obligations and, quite understandably, operate to maximize the return to their shareholders.

The philosophical differences between the Plans and the commercial insurers lead to very real differences in behavior.

Commercial insurers concentrate on low risk and/or high profit groups and individuals while Blue Cross and Blue Shield Plans recognize their obligation to serve the full range of their communities health coverage needs.

The Changing Environment

The impact of the commercial insurers' practices was to significantly change the environment in which Blue Cross and Blue Shield Plans operate.

In the early years, for example, the Plans followed the practice of community rating, meaning that rates were set in such a way as to spread the cost of coverage across all types of risks. They offered everyone in the community the same benefits at the same price -- regardless of their age, health status or employment. The commercial insurance companies quickly began moving toward a different system known as experience rating which, in its simplest form, means that the lowest risks pay the least for coverage and vice versa.

The effect of this change was that commercial insurers could offer coverage at lower rates to group policy holders who present the lowest risks and costs.

Blue Cross and Blue Shield Plans were forced to modify their practices to take into account what the commercial insurance companies were doing. They had no choice but to continue to be effective competitors in the large group market by adopting experience-based pricing. To lose the large group business would have left the Plans with only high-risk individuals and small groups who, alone, would have threatened the Plans' viability.

On the other hand, the Plans did not abandon small groups and individuals. It is these small groups and individuals who are finding it increasingly difficult to obtain affordable health care coverage from the commercial insurers -- or from anyone else -- and who must rely on the Plans to provide coverage at affordable rates.

In short, the Plans have been forced to adapt their practices to the world of the free market, but as tax-exempt organizations, they also maintain a pattern of behavior that is far more community-oriented than their competition.

Blue Cross and Blue Shield Plans' Business Practices
The Difference

Blue Cross and Blue Shield Plans' business practices are different and demonstrate Plans' unique community orientation in several ways.

The Plans return a higher percentage of premium payments to subscribers in the form of benefits than do the commercial insurers. Plans return, on average, 89 cents of each dollar collected in premiums from individual (nongroup) subscribers, compared with 54 cents, on average, for commercial insurers.

All Blue Cross and Blue Shield Plans offer individual coverage. Eleven million of our nearly 80 million subscribers are individuals who do not belong to groups and who represent, by definition, higher risks than group members.

It is precisely because of the high risks involved in covering individuals that in recent years a number of major insurance companies have publicly announced that they have stopped offering individual coverage. The president of one major commercial insurer stated that his first decision on taking office was to stop the sale of individual health insurance policies. Since then, he went on, the company has acquired 17 other companies "all of whom stopped the sale [of individual policies] the day we acquired them."

The reason that some commercial companies have stopped offering individual coverage is the volatility of the market and the very real problem of adverse selection as explained by a senior officer of one of the nation's largest insurance companies:

"It seems clear to us that a very significant part of our problem has been caused by the cumulative effect of policyholders selecting against the company, aggravated by the size of the rate increases which we've been obliged to make. For example, a family in their forties with children can easily be spending $300 a month for a health insurance plan. Now if there's a chance that they're not going to need that plan and they'd rather spend the money on something else, there's a good probability that they'll drop it. If there's a chance, however, that they're going to use that plan -- if somebody in the family has a health problem -- then the likelihood is that they'll keep it."

In addition to the fact that many commercial insurers are reducing their commitment to individual coverage, it is important to note that newer forms of health care coverage such as Health Maintenance Organizations (HMOs) and Preferred Provider Organizations (PPOs) often offer relatively little individual coverage, and that the rapidly growing number of employer self-funded programs, by definition, are not in the business of offering individual (non-group) coverage.

Blue Cross and Blue Shield Plans guarantee individuals who leave a group for any reason - and their family members - the right to convert to individual coverage without waiting periods and without exclusions for pre-existing medical conditions. This benefit helps protect laid-off workers and their families from major financial losses. Importantly, the right to automatic conversion applies to divorced spouses, widows, widowers and families of covered group members.

The right of conversion is nothing new for the Plans. They have always offered it voluntarily.

To force commercial insurers to come up to our standards, 30 states now require the right of conversion -- but that does not mean individuals can actually afford the coverage. When people leave their jobs, they are usually not in a position to buy insurance, and will do so only if they are already sick or think they might need the coverage. This makes it difficult to keep that coverage affordable since only the most high-risk, high-cost individuals are attracted.

Commercial insurers generally do not want to be in the business of providing coverage for these high risk individuals, and therefore may price their coverage at high rates. While it is available, it may not be affordable. For example, last year in Maryland a major commercial insurer, complying with state law, offered a laid-off worker individual coverage -- for an annual premium of $10,000. The Maryland Blue Cross and Blue Shield Plan provided comparable coverage to that individual for less than one-fifth of that rate - even though the individual had been a member of the competing commercial insurer's group for 15 years.

Finally, we make every effort to keep individual conversion coverage as affordable as possible. On a nationwide average basis the Plans pay out 97 cents in benefits for every dollar of premiums collected on conversion policies. This means that most of the Plans lose money on conversion policies since the three cents the Plans retain is not enough to cover administrative costs. Another way that we make conversion coverage more affordable is that some Plans voluntarily charge the person leaving the group a premium based on the group's rate.

Plans traditionally do not base the price of individual coverage on a person's medical condition. This is of significance for those who otherwise could not obtain affordable health care coverage. The president of a major health insurance company, representing the Health Insurance Association of America before a House committee in recent hearings commented on the quite different practices of the commercial carriers with respect to pricing of individual coverage:

"All relevant health-related information is evaluated by the underwriter and an assessment of risk is made. Applicants are then asked to pay a premium that reflects their level of risk. For those who's risk is very high, no offer can be made."

Even in today's highly competitive market, our practices with respect to individual coverage are substantially more liberal than commercial insurers. For example, Plans representing well over half our subscribers offer coverage regardless of medical condition. In those Plans, subscribers are accepted regardless of medical history. This means that, by definition, we cover people who we know, in advance, will incur extraordinarily high costs. Importantly, these practices are by no means just a relic of the past; Plans in California and North Carolina have just announced new open enrollment policies.

The value of these practices is demonstrated well by an excerpt from a report of the State Insurance Commissioner in New York:

"Based on our survey of eight commercial carriers, three offer no individual health insurance coverage and those carriers that do provide individual coverage require evidence of insurability before the policy is issued. Uninsurables have no option to obtain health insurance from commercial insurance carriers on an individual basis and substandard risks pay an additional premium based on the severity of their pre-existing condition or have a waiver of coverage attached to their policy for a known condition."

Blue Cross and Blue Shield Plans continue to provide small group coverage that many commercial insurers have conclude is undesirable high cost/high risk business that they will no longer provide. The Plans have always remained in the small group market, even as commercial insurers have come and gone.

One large commercial insurer noted recently that many companies withdrew from small group coverage following the "trauma" of the mid-1970's only to return in the early 1980's "when companies again saw small group business as attractive both for their agents and for its potential profit. However, now once again, following the losses of 1981, confidence has been shaken. In fact, the chief executive officer of one company very active in small group has been reported as saying there is no way a company can any longer operate profitably in this business."

Those commercial insurers who remain in the small group market are highly selective in the risks they accept, often excluding group members or their families for pre-existing medical conditions.

Blue Cross and Blue Shield Plans accept small groups without excluding employees in the groups -- or their family members -- because of medical problems. Nearly all Plans accept groups as small as ten on those terms, and many Plans accept groups as small as five and even three with no restrictions because of medical problems. This practice makes Blue Cross and Blue Shield Plans extremely vulnerable to enrolling high-cost subscribers, those who already have a medical problem.

These differences in definition and practice are not simply an academic point. To the thousands of small businesses, to the entrepeneurial start-ups that provide future job opportunities, adequate and affordable health care coverage for all employees is an expected benefit. If such coverage were not available, there would be a significant impact on the ability of these companies to hire and retain qualified employees.

Blue Cross and Blue Shield Plans consistently set the standard for community-wide cost containment. The Plans engage in activities that benefit not just their own operations but also their competitors' and the community at large. For example, a majority of Plans state in their hospital payment contracts that they will not pay for costs incurred against the recommendations of local health planning commissions. Clearly if such action by Plans prevents an unnecessary hospital wing from being built, the whole community benefits by avoiding unnecessary health care costs.

Another example is our Medical Necessity Program in which the Plans work with national medical specialty organizations and independent consultants to define and apply good standards of practice to the utilization of services. To date, this has involved about 85 individual procedures including respiratory therapy, hospital admission testing and cardiac care. One study of hospital admission testing resulted in savings of $22 per admission. Our leadership in this area is illustrated by the fact that government programs frequently adopt the findings of the Medical Necessity Program.

Finally, the Plans have been heavily involved in improving hospital administrative procedures including fraud detection, adjustment for changes in the pattern of procedures due to utilization review and billing or accounting error reduction. We believe that Plans do far more of this kind of work than does any other entity and that the community-wide impact is significant.

Competitive Position

One point is clear. The Plans accept subscribers -- individuals, small group members -- who are not accepted by or who cannot afford quality coverage from any other providers of health care coverage. And we provide such coverage in good times and bad. As an inevitable result, we end up with a disproportionate share of high risk, high cost individuals.

A recent study at a New York State Plan showed that one third of subscribers were rated by an outside consultant as "high risk." These subscribers had health costs 84 percent above average and accounted for one-half of all claims paid by the Plan. Yet the New York Plan and other Plans continue to accept those higher risks -- and higher costs.

The Plans' ability to compete and to perform their community service role has been made more difficult by the growth of self-funded health benefit programs that have taken an increasing share of the large group market, due in part to the influence of federal legislation. Self-funded programs which include both single employer and multi-employer formats, have been freed -- by ERISA -- from state regulation of their benefits. The Plans -- and commercial insurers -- on the other hand, are mandated by state law to offer benefits that raise the cost of coverage to employers. The same ERISA provisions protect self-funded programs from state and federal taxation.

All of this makes it much more difficult for the Plans to compete with commercial insurers and self-funded groups -- while continuing to provide coverage to high-risk segments of the market.

A Delicate Balance

That we can compete at all -- while covering so many high risks -- is a tribute to a very delicate balance developed over 50 years of operations.

Our aggressive pursuit of cost containment is one key to the Plans' ability to compete while carrying the costs of high risk subscribers. We negotiate rates with doctors, hospitals and other providers so as to establish the lowest possible costs for our subscribers.

Then there is the tax exemption itself. Combined with our cost containment activities, the absence of taxation allows most Plans to achieve that delicate balance between income and expenses.

Impact of Taxing the Plans

Section 1012 of the tax bill approved by the House in December (HR 3838) adds a new provision to the tax code -- paragraph 501 (m) -- that (with certain exceptions) denies tax-exempt status to organizations that provide commercial-type insurance. The House Ways and Means Committee Report makes it clear that the provision is aimed directly at Blue Cross and Blue Shield Plans.

What this provision means is that we would be forced to pay taxes on the amounts the Plans must add to reserves. Suggesting that the Plans' net operating gains added to reserves be taxed as profits is to totally misunderstand how the Plans work and to misunderstand the importance of reserves.

Plans must generally maintain reserves adequate to cover two-to-three months' claims in order to protect subscribers from unpredictable events. The Plans must have some net operating gains in order to add to those reserves to keep them at that level because of inflation and new subscribers.

The tragic experience of AIDS is an example of how important reserves are. Empire Blue Cross and Blue Shield, based in New York City has total individual and group subscribers numbering 10 million and reserves that currently stand at about $270 million.

The federal government recently estimated that health care costs for a single AIDS victim will likely run between $140,000 and $150,000. At that cost, approximately 2000 unanticipated AIDS cases -- out of New York's 10 million subscribers -- would wipe out the Plan's entire reserve. That number of possible cases is not unreasonable when you consider that the Plan knowingly accepts subscribers already diagnosed as having AIDS.

When reserves build up to more than necessary levels, it is our subscribers who receive the benefits, either through stable rates, refunds or rebates.

On the other hand, if the annual amounts added to reserves are taxed, the Plans would need to make more money to maintain the income/expense balance and keep their reserves at adequate levels.

Obviously, the Plans would need to look very carefully at how they would be able to absorb the new costs of taxation. Competition among all providers of large group coverage is so intense that in some cases premium differences of less than one percent on large groups may determine who wins a bid. If large group rates offered by the Plans go up, the Plans could lose significant amounts of business, reducing their economies of scale and their ability to effectively deal with health care providers to hold down costs. That would further upset the balance working into a spiral of ever increasing costs and reduced subscriber base.

The immediate impact of taxation would be felt through increased premiums for those high risk individuals and small groups least able to afford it. Consequently, many individuals now protected by the Plans could be faced with such high premiums that they would be forced to give up their coverage, with nowhere else to go.

Ultimately, it is questionable how long the Plans could maintain premiums adequate to cover the new cost of taxation and remain competitive. If individual rates go up, many lower risk individuals would drop their coverage altogether or would seek coverage elsewhere, leaving the Plans with the higher risk individuals and forcing even higher costs to be shared among even fewer people. The Plans would ultimately be forced to be more selective in providing coverage for the higher risks.

The bottom line is clear: many people -- individuals and small group members -- will be priced out of the market and/or Plans will have to change their practices to limit access to coverage. In both cases, the result will be hundreds of thousands of people unable to obtain affordable health care coverage.

Competitive Position Worsened

The House-passed bill makes it clear that health maintenance organizations (HMOs) and voluntary employee benefit associations (self-funded plans) are not to be taxed along with Blue Cross and Blue Shield Plans. We must question why the bill overlooks the enormous community service contribution of the Blue Cross and Blue Shield Plans, while placing the Plans at a distinct competitive disadvantage, compared to these "non-traditional" insurers.

These "non-traditional" insurers are already the fastest growing segments of the health care coverage market. If they are given a further advantage over the Plans -- while they continue to avoid high risk, high cost individuals and small groups -- the balance would be upset.

The spiral of increased risk and cost combined with a reduced subscriber base would accelerate, threatening the way our organization serves the American people.

Impact on the Government

The delicate balance of the Plans would not be the only victim of the loss of tax exemption.

The federal government itself would be a major loser as the disproportionately high cost of health care for hundreds of thousands of high risk individuals and small group members is passed on to the public sector.

A hypothetical but very conservative analysis makes the impact of taxation all too clear.

Blue Cross and Blue Shield Plans currently cover 11 million individual subscribers. Assume that only five percent of this number -- which would total more than half a million people -- are high risk individuals who will not be able to afford significant premium increases. (This is a conservative assumption in light of the New York study that revealed that 30 percent of individual and small group subscribers are "high risk.")

Now assume that each of these newly uncovered individuals incur only $1600 dollars in health care costs each year. Again, this is conservative since $1600 approximates the estimated spending on health care for the average American in 1984.

This all means that 550,000 high-risk individuals would incur a total of $880 million dollars in health care costs each year that would not be reimbursed by any form of health care coverage. That compares to $1.7 billion that the House Ways and Means Committee predicts would be generated as a result of taxing the Plans over next five years. In other words in two years the cost burdens of uncovered individuals would exceed the projected government revenues from five years of taxing our Plans.

While some of that nearly $1 billion annual shortfall would be a cost to the health care system in terms of enormous new bad debts, it is absolutely inevitable that a major portion would end up on the doorstep of government. It is hard to believe that government costs would not, therefore, increase by substantially more than the revenue gained by taxing the Plans.

What is very important to remember is the basic purpose of the tax exemption: it is, after all, intended to reduce burdens on the government. Blue Cross and Blue Shield Plans have been fulfilling that role for 50 years. If the Plans are unable to continue their community function of covering the highest risks, the government would have no choice but to step in.

Conclusion

It was over 50 years ago, when the great Depression was ravaging our nation, that Blue Cross and Blue Shield Plans were born through the vision, courage and determination of individuals in communities throughout the nation. These people -- considered to be impractical dreamers by many both within and without the health field -- had a vision of being able to provide, within the private sector, affordable access to health care.

The fact that they succeeded beyond their fondest dreams, and that the Plans have continued to meet the obligations of their communities despite an ever-increasing amount of competition, is an extraordinary accomplishment.

Our Plans have filled a void that most other nations filled with massive government programs. They have worked hard to achieve and maintain a unique and delicate balance between competitive survival and community service. The story of how well they have succeeded is best told by the millions of high risk individuals who have been protected from economic disaster while having the added security of knowing they can secure quality health care when they and their families need it.

For the Congress to turn its back on the performance of our Plans would be a tragedy of enormous proportion. And in purely bottom-line terms, it would be highly counterproductive to the government's job of reducing spending and balancing the federal budget.

The well known adage "if it ain't broke, don't fix it" could be applied to our Plans and the service they provide their communities. However, the current situation merits a stronger version of the adage, namely, "If it ain't broke, don't break it."

Blue Cross and Blue Shield Plans are unique. They work. Clearly, there is no rational reason to tamper with their ability to serve communities across America nor with the right of millions of Americans to secure affordable, quality health care coverage through the private sector.

The CHAIRMAN. Thank you, sir. Mr. MacDonald.

STATEMENT OF JAMES G. MacDONALD, CHAIRMAN, TEACHERS INSURANCE AND ANNUITY ASSOCIATION OF AMERICA-COLLEGE RETIREMENT EQUITIES FUND, NEW YORK, NY

Mr. MACDONALD. Thank you, Senator.

I am here today to urge that you continue the longstanding tax exemption of Teachers Insurance and Annuity Association, TIAA, and the College Retirement Equities Fund, CREF that H.R. 3838 would terminate.

First though, let me give you just a little bit of background on TIAA.

It was started in 1918, but its history goes back to 1906. Andrew Carnegie, having joined the board of Cornell University, learned that colleges had no system for providing retirement income for professors. He worried about this and what it could do to the quality of education. So he decided to fund a free pension system. The Carnegie Foundation for the Advancement of Teaching was established to administer it.

By 1916, it could already be seen that one man's wealth, great as it might have been, was not enough to provide pensions for a rapidly growing educational community. So the foundation's trustees began a search for a practical and durable new system. A commission was created, made up of representatives of the various educational associations, and technical advice was provided by the actuarial societies.

At that time, the few pensions that did exist in business and in industry were carefully defined as gratuities, or gifts to employees. The benefits were not vested; the funding was not systematic; and, of course, there were no guarantees.

The commission sought something that was vastly different. Its concept of what a pension ought to be included some unique features at that time. Benefits were to be contractually guaranteed; they were to be immediately vested in the individual; they were to be fully funded; and they were to be portable so that an educator could move from one college to another college as his career advanced and the needs of the institution changed.

The final challenge for the commission was to create a central structure that would give life to these revolutionary pension ideas. The pension system thus designed was way ahead of its time and in many respects it still is.

The proper supervision of this new system was deemed essential, and so the commission turned to the then strictest regulator of insurance and annuity contracts in the Nation, the New York Insurance Department, and a new system, TIAA, was accordingly formed in New York State in 1918.

The Revenue Service determined that TIAA was tax exempt because it was organized and operated exclusively for educational and charitable purposes and it served only colleges, universities and other related educational organizations.

Subsequently, the Revenue Act of 1926 recognized that the earnings of business and industrial pension trusts were also exempt from taxation as income, as they always had been.

The point I would like to make is that TIAA's present structure and the annuity contracts that carry out its objectives are based on a unique and pioneering history. Its vesting, funding, portability and annuity guarantees are features that have for many decades been recognized as the best of pension principles.

TIAA takes the form of an insurance company, but one that is chartered to serve nonprofit educational institutions exclusively.

CREF was formed by a special act of the New York Legislature in 1952 as a companion organization to TIAA and has the same purpose and tax exemption.

In closing, TIAA's primary purpose is to provide a portable Nation-wide pension system and thereby aid and strengthen higher education. The particular form of TIAA-CREF gives no special advantage when compared with pension programs of other organizations, and under all such plans, including TIAA and CREF, benefits are taxed when retirement income is received.

I would like to say that I am joined in this petition for a continuation of TIAA-CREF's exemption by the American Council on Education, the Association of American Universities, the American Association of State Colleges and Universities, the National Association of College and University Business Officers, and the National Association of Independent Colleges and Universities.

I thank you very much for your attention, and I would be pleased to try to answer any questions.

The CHAIRMAN. Thank you, sir.

Before we take questions of the two of you—and both of your statements will be in the record in full—I would like to take Congressman Frenzel. Just stay at the table. Bill, why don't you take that microphone right next to them. He has got an entirely unrelated subject to testify on, and we will take him first and then come back to the two of you.

[The prepared written statement of Mr. MacDonald follows:]

BEFORE THE SENATE FINANCE COMMITTEE

Hearings on H.R. 3838, February 4, 1986

STATEMENT OF JAMES G. MacDONALD
Chairman and Chief Executive Officer
Teachers Insurance and Annuity Association
and
College Retirement Equities Fund

PROPOSED TAXATION OF PENSION PLAN FUNDS HELD BY TIAA AND CREF

Mr. Chairman and members of the Committee, I am James MacDonald, Chairman and Chief Executive Officer of Teachers Insurance and Annuity Association and College Retirement Equities Fund, the nationwide pension system for higher education.

My purpose today is to urge continuation of the long-standing tax exemption for pension plan funds held by TIAA-CREF, which exemption would be terminated under Section 1012 of H.R. 3838.

It is well established under national pension policy that pensions should not be taxed at the plan level, but taxed as income when received. Currently, TIAA-CREF's tax exemption reflects that policy and puts higher education's pension plans on an equal footing with other pension plans.

It is with the objective of maintaining that equal footing that I appear before you today. Continuing TIAA-CREF's tax exemption does not put it in a preferential position; repealing the exemption would put TIAA-CREF and the institutions it serves in an inferior position.

The TIAA-CREF system was cited as an exemplary model of pension funding, vesting, and portability in the Congressional discussions leading to ERISA. I can only conclude that the proposal in H.R. 3838 to terminate

TIAA-CREF's historic tax exemption is based on an incomplete or inaccurate understanding of the system.

History and Operation of TIAA-CREF. TIAA was created by college representatives in 1918 to aid higher education by providing a pension system to replace the free college pensions funded by Andrew Carnegie (after it became clear that the financial burden of college pensions was too great for a philanthropic organization). The Carnegie Corporation of New York provided an initial endowment for TIAA and made substantial additional contributions over the period from 1918 through 1957. Further contributions in support of TIAA's programs have been made by the Ford Foundation and other charitable institutions. A companion organization, CREF, was established in 1952 to complement TIAA's college pensions through the introduction of the first variable retirement annuity.

TIAA was formed as an insurance company because this structure provided the best means of assuring adequate regulatory oversight of its funds. New York domicile was chosen because the New York State Department of Insurance was believed to offer the most effective supervision then available. CREF was formed by a Special Act of the New York Legislature and is subject to similar supervision by the New York State Department of Insurance. Both organizations were formed as nonprofit corporations, exclusively for educational purposes. As such, they are subject to the restrictions against any private inurement of profits not only under their charter limitations but also under charitable trust law.

TIAA-CREF's nationwide pension system is essentially a unique multi-employer pension fund. About 98% of TIAA's assets are dedicated to retirement annuities under the plans of educational institutions, and 100% of CREF's assets are so dedicated. TIAA-CREF's retirement system has for more than 65 years operated as an arm of higher education, providing the retirement programs of colleges and universities throughout the fifty states. In addition, independent schools, nonprofit research organizations, libraries, museums and educational associations participate in this system, which currently covers more than 3,600 educational organizations. TIAA-CREF retirement plans are in operation at about 87% of private colleges and universities, and those institutions employ about 89% of faculty in all private colleges and universities. TIAA-CREF plans are also in effect in 63% of publicly-supported colleges and universities, which coincidentally employ 63% of faculty in all public colleges and universities. In most public institutions, the TIAA-CREF plan is an alternative to a public retirement system. TIAA-CREF plans also cover large numbers of administrative, clerical and service employees in educational institutions. TIAA-CREF has approximately one million participants, including about 150,000 retired employees of educational institutions now receiving pension income. Most of these participants are dependent upon TIAA-CREF and Social Security for their principal retirement income.

Tax-Exempt Status of TIAA-CREF. TIAA in 1920, and CREF in 1953, were determined by the Internal Revenue Service to be exempt from Federal income taxes because they are organized and operated exclusively for educational purposes. The charters of TIAA and CREF make their programs available only to nonprofit tax-exempt educational organizations. Participating institutions have relied on such exemption in depositing their retirement funds with TIAA and CREF over many years. The pension plans of business and industrial employers, under various provisions of the Internal Revenue Code, are afforded the same treatment for their plans that TIAA-CREF's tax-exemption affords for plans of educational institutions.

H.R. 3838 Would Tax TIAA-CREF Pension Plans. The President's Tax Proposals for Fairness, Growth, and Simplicity did not propose to tax pension plans. However, the House Bill in Section 1012 would terminate the long-standing tax exemption of the TIAA-CREF pension system. Further, the provision would be retroactive in its application to the pension funds contributed to TIAA-CREF in reliance on its tax-exempt status.

Yet, H.R. 3838 would continue the tax exemption provided generally for other pension funds--those of business and industrial as well as charitable organizations--and whether held in self-administered or bank-managed pension funds, mutual fund custodial accounts or insurance company segregated accounts. Tax exemption would also continue for the pension activities of fraternal organizations such as the Knights of Columbus. Moreover, the Bill (I think appropriately) exempts the pension funds of Mutual of America, a nonprofit, tax-exempt insurance company established to serve social welfare organizations in a manner similar to the way TIAA-CREF serves higher education.

Effect of Proposal to Tax TIAA. The termination of TIAA's tax exemption under proposed Section 1012 would presumably result in the taxation of TIAA under Subchapter L of the Code as if it were a commercial insurance company. (CREF's technical status under the proposed statute would be different and is discussed below.) This change in treatment means that required additions to contingency reserves, including securities valuation reserves mandated under state law, would not be deductible under Subchapter L and therefore would result in tax liabilities. This taxation would directly reduce the pension benefits payable to TIAA retirees, even though these contingency reserves are used for the sole purpose of benefitting participants.

Contingency reserves are necessary because all TIAA retirement annuity contracts contain minimum lifetime income guarantees. The contingency reserves are established to protect these minimum income levels against unfavorable mortality and investment experience. As retirement annuity commitments have grown, these reserves, initially established by charitable grants, have been maintained at a level (1) that meets the standards mandated by the insurance laws and regulations of New York and other states, and (2) that provides adequate protection against the risk of TIAA's defaulting on its contractual guarantees. All TIAA income in excess of minimum reserve requirements is credited to participants in the form of dividends to increase the amount of annuity income during retirement.

TIAA's pension operations, including the contingency reserves that support its pension guarantees, cannot fairly be treated the same as the operations of commercial insurance companies. Its mission is to carry out a function essential to each educational institution--the provision of a portable retirement system for faculty and staff.

The contrasts between TIAA's operations and those of commercial insurers include the following fundamental distinctions:

(1) TIAA was organized to aid higher education and is operated exclusively for educational and charitable purposes. It is subject to the charitable trust principles of common law and New York statutes, which are enforced by the Attorney General and courts of New York State.

(2) TIAA's initial reserves were established by a charitable grant and subsequently supplemented by further charitable grants.

(3) TIAA pension annuities are designed for and available only to nonprofit educational employers that qualify for tax exemption as

described in Section 501(c)(3) of the Code or as publicly-supported educational institutions.

(4) All of TIAA's pension funds have been contributed and accumulated in reliance on TIAA's tax exemption. This exemption was reasonably believed to make it unnecessary for TIAA to adopt, or even consider, a structure that would minimize taxes, or for participating institutions to consider alternative pension arrangements.

(5) The role and disposition of TIAA's contingency reserves are distinctly different from the surplus and contingency reserves of commercial insurance companies, whether stock or mutual. TIAA's contingency reserves are maintained solely to enable the company to meet its contractual guarantees in the event of unforeseeable adverse circumstances. As the risk of encountering such adverse circumstances subsides during the annuity pay-out period, any unused contingency reserves are systematically paid out to retirees as annuity income.

The procedure is as follows: During the annuity accumulation stage, all earnings in excess of those needed to meet contractual guarantees and administrative expenses are credited to participants as dividends, except for amounts set aside in contingency reserves each year. As a result of these regular set-asides for contingencies, an adequate level of financial protection is gradually developed by each generation of participants.

During the annuity pay-out period, however, the need for back-up financial protection decreases year-by-year and ceases entirely when annuity payments terminate. Accordingly, the contingency reserves that remain unused at the end of the accumulation period are paid out to retirees in the form of dividends which increase the total level of retirement income provided. For example, since 1982 TIAA has been able to base its pay-out annuity dividend scale on a 12% interest rate despite the fact that most of the assets underlying these annuities were invested many years ago when prevailing interest rates were lower.

In this way, TIAA's contingency reserves enable it to provide a high level of financial protection against unforeseen events and a lifetime income guarantee to participants.

(6) TIAA's contingency reserves (like all its assets) are restricted by law to exclusive use for the benefit of nonprofit educational institutions.

Thus, every dollar of pension contributions and the income therefrom are used for pension or related benefits for tax-exempt educational institutions. In contrast, the surplus and contingency reserves of a commercial stock insurance company that are not needed to meet policy commitments constitute profits available for distribution to stockholders, or, in the case of both stock and mutual companies, are available at their discretion to expand into brokerage, banking, financial consulting, or other business enterprises. Thus, commercial insurers differ from TIAA in that they may accumulate their reserves, profits, and surplus for purposes which ultimately inure to private commercial benefit. TIAA cannot use any of its contingency funds to expand into other types of business activities.

Problems of Restructuring the TIAA System. It has been suggested that the tax consequences of the proposal to repeal TIAA's tax exemption could be eliminated by "a simple restructuring which can easily be accomplished." In fact, the problems associated with restructuring would be formidable. Restructuring the system would require substantial changes for TIAA and participating institutions.

The only way for TIAA to restructure to eliminate taxes would be to eliminate guarantees. For existing pension funds, these guarantees could not be eliminated without obtaining the consent of nearly one million contractholders and presumably their employers who have provided funding for such pensions, as well as the consent of state insurance departments. For new pension funds, the elimination of guarantees would completely change the nature of the TIAA component of the system, would require issuance of new contracts, or entering into other kinds of retirement arrangements. For example, no taxable income would result with respect to new pension funds if they were received in segregated asset accounts without any annuity guarantees. However, this would substantially reduce the retirement security currently being provided for participating institutions and participants.

As a result of the loss of guarantees in their pension plans, the colleges may find it appropriate to adopt other pension arrangements. This would lead to fragmentation of their nationwide pension system, would impair portability and reduce faculty mobility, and would be disruptive and costly to the colleges.

The Impact of H.R. 3838 on CREF. The purpose to be served by eliminating CREF's tax exemption is puzzling. Although it is unclear whether CREF would meet the definition of a life insurance company under the Code, it operates like an insurance company's segregated-asset account, and such accounts are in effect exempt from Federal income taxation. Every dollar of CREF assets, whether representing capital or income, is automatically credited to its retirement annuities. As a fully participating variable annuity fund, CREF makes no guarantees and has no contingency reserves.

Unless CREF is treated as the equivalent of a segregated-asset account for tax purposes, the termination of CREF's exempt status might impose serious hardships on the CREF pension funds. CREF might then become subject to ordinary corporate taxes on the income from all of its pension funds, without the 100% deduction against such income that would be available if precisely the same operations were carried out through the segregated account of an insurance company. This would result in a drastic reduction in CREF's pension benefits.

It might be asked, why not reconstruct CREF as a segregated-asset account of TIAA? This might be possible, but the process would be complex, lengthy and would necessarily require actions by many state legislatures and insurance departments. The process would also be costly and totally wasteful, since it would have no purpose except to continue the current status of CREF's nontaxability under the Code.

Conclusion. For the reasons stated above, we urge the Committee to continue the long-standing tax exemption of the TIAA-CREF pension system.

STATEMENT OF HON. BILL FRENZEL, U.S. HOUSE OF REPRESENTATIVES, STATE OF MINNESOTA

Congressman **Frenzel**. Mr. Chairman, I thank you for hearing me. I apologize to the committee for my tardiness.

I have a lot to say about the tax bill, but much of it has been heard. You gentlemen know more about it than I do anyway, so I am going to confine myself to one feature on which I believe the committee has not held hearings, and that is the political contributions tax credit.

The President repealed it in his proposal, saved himself a little bit over a billion dollars. In our committee, we agreed to the repeal by a vote of 6 to 20. Then there was a vote on the so-called McHugh amendment, and that was defeated in the committee by a majority of Republicans and a majority of Democrats.

On the floor, that amendment was accepted. That cost about half a billion dollars over the 5-year timeframe.

It happens to benefit mostly us. It looks like a terrible case of greed and selfishness on the part of the Congress.

About three-quarters of these contributions are made to encumbents. And if we are all going to sacrifice by giving up some tax preferences, it seems to me Congress ought to be willing to give it up too.

So I would simply say that the McHugh amendment in the House bill provides the Senate with a great opportunity to use the half a billion dollars for something worthwhile in the savings incentive or capital accumulation or whatever is your will; at the same time removing the embarrassment of looking as though Congress were the only beneficiary; they got a better deal than it had before the bill was put together.

Thank you very much, Mr. Chairman.

[The prepared written statement of Congressman Frenzel follows:]

TESTIMONY OF REP. BILL FRENZEL
TO SENATE FINANCE COMMITTEE
2-4-86

Mr. Chairman:

I have lots to say about the House Tax Bill, but that can wait for another day. Today I will deal only with one feature, The Political Contributions Tax Credit.

1. Current law provides a tax credit of 50%, maximum $50 per individual, of contributions to candidates and certain political campaign organizations.
2. In 1982, this credit was claimed on 5.2 million returns, about 6.6% of all individual returns.
3. The President's proposal included repeal of the present credit. The Rostenkowski proposal was the same. The revenue effect was $257 million in FY 87, and $1.1 billion over 5 years.
4. During the Ways and Means Committee markup, an amendment was offered to the Rostenkowski proposal to restore the current tax credit. On a recorded vote of 6-20, the amendment was rejected by a majority of Democrats and a majority of Republicans.
5. Then the amendment now in the House was offered and defeated 14-21. Again a majority of both parties opposed the amendment.
6. The McHugh-Tauke amendment was made in order by the Rules Committee and passed on the House Floor 230-196. No member of the Ways and Means Committee spoke in its favor.
7. The McHugh-Tauke amendment, now in the House Bill, provides a 100% tax credit, maximum $100, on contributions to Congressional candidates from donors' own state only. Revenue impact is $500 million over 5 years.

8. I respectfully suggest that the Senate remove the credit from its bill, as the President proposed, and the Ways and Means Committee recommended.

   a. The proposed credit is too expensive. The $500 million savings (revenue enhancement) is desperately needed for capital formation incentives and other repairs to the House bill.

   b. The proposed credit is not fair. The McHugh-Tauke version doubles the Tax Credit for relatively affluent taxpayers who can afford larger contributions of $50-$100, while the Bill diminishes the charitable contribution deductions for non-itemizers (usually less affluent taxpayers) and reduces pension contributions. The proposed credit asks low-income Americans to subsidize political contributions by higher-income Americans.

   c. The proposed credit is selfish. Only contributions to Congressional candidates qualify. The House greedily feathered its own nest. I hope the Senate won't, especially in a Tax Bill which reduces other personal credits and deductions.

   d. The proposed credit is harmful to the election processes. In favoring Congressional candidates only, it gives no credit for contributions to our two great parties. While individual, personal, and PAC contributions rise, party contributions to Congressional candidates are continuing to decline, amounting to less than 2% of all such contributions in 1984.

9. In summary, Mr. Chairman, I suggest the Finance Committee seize this fortuitous opportunity to excise a patently - blatantly - self-serving tax credit from the House Bill. In one stroke, the Committee can eradicate an embarrassing House mistake, and set aside $500 million of valuable revenue for real reform of its own.

The **CHAIRMAN**. Senator Heinz.

Senator **HEINZ**. Mr. Chairman, I want to address some questions to Mr. Tresnowski, representing Blue Cross-Blue Shield.

The **CHAIRMAN**. I wonder if we might finish with Congressman Frenzel first on his subject, and let him go, and then we will get back to these other two gentlemen.

Senator **HEINZ**. That is fine with me, Mr. Chairman. I will pass then for now.

The **CHAIRMAN**. You have no questions of Congressman Frenzel?

Senator **HEINZ**. No.

The **CHAIRMAN**. All right.

Let me ask you, Bill——

Senator **HEINZ**. I have been gearing up for the other ones.

The **CHAIRMAN**. You have a lot of questions, but not on this subject.

Senator **HEINZ**. Not on this subject.

The **CHAIRMAN**. Let me ask you a quick question. Do you think the whole idea of the tax credit is a bad idea, period? Whether it was the previous law, the current law, whether or not you include other candidates or do not include other candidates, you don't like the idea.

Congresman **FRENZEL**. I like the idea as it existed in the old law. If we were going to tax reform, and if we were going to kill all these credits, particularly if we were going to direct ourselves toward non-return filing in the future, it seemed to me that that was the sacrifice Congress should make.

The form that the House bill is in though is particularly greedy because it applies only to Federal candidates.

The previous tax credit applied to candidates for a State office and the political parties. And I suspect if anybody needs helps, it is the political parties. But this particular amendment that is in the House bill refers only to people seeking Federal office and, therefore, I think it makes us look bad on its face. It also costs us half a billion dollars which could be used elsewhere. In the best of all possible worlds I would like to keep the current law.

The **CHAIRMAN**. A second question. The argument that this unduly favors the rich, my experience with this is interesting. Oregon has an identical law, so that you can get $100 for $100 contribution. You can get $50 on your State return and $50 on your Federal return. And I have used it, and I found it a very good selling tool for lower contributions.

For those who are going to give you $500 or $1,000, I don't think it makes much difference to them whether this credit exists or not. They are going to give it. But I found it a very good selling tool for $20, $30, $40, $50 contributions.

Congressman **FRENZEL**. You are very fortunate today if you have it, and it probably means you are a pretty good salesman. Most of the tracks written by political scientists indicate that this is not a very good incentive; that it takes the same criticism as the FIS, for instance; that it rewards you for something you were going to do anyway at the end of the year.

It is true also that low-income people contributing at the normal time in an election cycle have to wait probably 6 or 8 months before they get their money back. It does not seem that this is a big incentive. They do not seem to feel that it is a great incentive for them.

The **CHAIRMAN**. Let me ask you a last question. Russell Long is not here, but I remember he once proposed the idea that the way to make this effective so that you would get small donors is to have some way that you could get your money back from the bank right away. You give $50 to the campaign, and the campaign gives you a chit of some kind, and you go to the bank and get your money back the same day. That would remove the problem of the 8-month wait.

Congressman **FRENZEL**. Well I agree with you. That is a question, I suppose, for Senator Mathias' committee. But you are right, that would give immediate incentive. There is no immediate incentive now, particularly for the little guy. The big guy probably doesn't need it.

Senator **MOYNIHAN**. Mr. Chairman, I have been told that "implaca" means "perish." They have all kinds of immediate incentives. [Laughter.]

The **CHAIRMAN**. Let's see, who do we have? Senator Chafee.

Senator **CHAFEE**. Thank you, Mr. Chairman.

I want to compliment Congressman Frenzel because I think the point he makes is good. I am a little gun shy of the Federal Government paying the total amount of a contribution. In effect that is what the House bill does. You could pay $100 to a candidate and you would get $100 off your tax, a tax credit. So the Federal Government has paid it all. Whereas, under the current system, the Federal Government just pays half.

Now what the amount should be, I don't know. Currently, it is $50. Whether it should be $100, I don't know. I tend to agree with Congressman Frenzel that we ought to keep the present system. And that is your position? You tilt toward keeping it.

Congressman **FRENZEL**. Yes; it is.

Senator **CHAFEE**. Well if you do that, then how much revenue would we lose?

Congressman **FRENZEL**. Well that would cost you an extra half a billion dollars, which is why you probably won't want to do it.

The **CHAIRMAN**. You mean roughly a billion for the whole credit as it currently is?

Congressman **FRENZEL**. That's correct, $1.1 billion.

Senator **CHAFEE**. For the $100 credit is a billion.

Congressman **FRENZEL**. The existing law is $1.1. The House form is half a billion.

The problem is, Senator, that we are asking everybody to sacrifice, saying Gramm-Rudman is cutting education, the disadvantaged and elderly. And here we are sitting around doubling up on some fairly affluent contributors, but only if they contribute to us. It is a pretty hard sell at a time of a squeeze.

Senator **CHAFEE**. Well I couldn't agree with you more on that particular point. I guess the real question is: what is the argument for even keeping the existing system?

Congressman **FRENZEL**. Well I am saying that in the best of all possible worlds I would like the current law. And if we ever get out of our deficit bind, fine. I think for now probably you ought to repeal the whole thing.

Senator **CHAFEE**. Thank you.

The **Chairman**. Senator Durenberger.

Senator **Durenberger**. No questions, Mr. Chairman.

The **Chairman**. Senator Moynihan.

Senator **Moynihan**. No questions, Mr. Chairman.

The **Chairman**. Senator Bradley.

Senator **Bradley**. Mr. Frenzel, would you be in favor of denying as a business deduction any expenses related to political action committees?

Congressman **Frenzel**. I would not, Senator. As you know, the current law provides for both unions and corporations the right to use Treasury money or membership money in the administration of political action committees.

My judgment is that political action committees have had an extremely positive effect of bringing people into the political process and, in fact, probably are the largest contributor to increased participation in politics in my political lifetime. So I would not favor that. But it is a legitimate item for consideration.

Senator **Bradley**. Would you draw a distinction between the idea of a tax credit and the political action committee?

Congressman **Frenzel**. I think obviously they both relate to elections, and money is spent to influence the outcome of elections. That is a basis similarity.

There are pretty strong differences too because the tax credit as it appears in the House bill relates only to Federal candidates and only to candidates, not to parties or to other political entities.

I think the facts work with a much broader brush.

Senator **Bradley**. So you would do nothing to change the present law that affects political action committees?

Congressman **Frenzel**. At the moment, I have some changes in mind. They are the nature of a comprehensive bill. But I have not suggested that either we reduce limitations or do such things as Senator Boren has suggested.

Senator **Bradley**. Thank you very much.

The **Chairman**. Senator Long and then Senator Pryor.

Senator **Long**. Mr. Frenzel, as far as my personal situation is concerned, there is every reason to think I ought to go along with you. In the first place, I am not planning to run for office again. In the second place, even if I did, I can raise money. I have proved it. And I don't have any doubt that if I was running for reelection, it would be a Republican complaining about the difficulty of raising money, not me. I have made enough friends among business and elsewhere. I can raise money to finance a campaign. I have some of my own I could put into it if need be. If I run short, I could sign a note, and I have credit so that I could do it.

But there is something wrong with this system, where you can have two candidates seeking public office. A poll would indicate that each had about the same support among the public, and yet one has 10 times the access to the public by way of television and media generally, or 10 times the money with which to seek votes. Now Democrats typically complain about that.

I sponsored that $1 tax checkoff that the President recommended repealing. For what purpose? To try to see to it that the Democratic candidate has an equal chance to be heard with the Republican candidate. And we finally worked out that third party situation.

I can see some technical difficulties here. Let me ask you a philosophical question. Why in the name of good government shouldn't we try to see to it that two candidates, equally popular among the public, ought to have an equal chance to be heard?

Congressman FRENZEL. I think that that is a laudable ambition, Senator, but I would point out that all incumbents start with a 10-to-1 advantage the other way against all challengers. So there tends to be, at least in the House in which I operate, a little different starting point for all of us.

But I don't believe that the taxpayers should be playing a major role in the free election process. And I cite your ex-colleague who talks about the IRS taking away our right to economic well-being, and the FCC taking away our right to free speech, and the FEC taking away our right for unrestricted participation in elections.

I happen to be the author of a bill that created the FEC. I don't feel that strongly about it. But I really don't believe in a very strong Federal presence in elections to write suspected inequities. I think that every time we get to tinkering, we tend to create situations that we may regret later.

Senator LONG. Well, Mr. Frenzel, when I fought that $1 tax check-off battle, former Senator Albert Gore was a member of the committee. Did you know him during the time he served?

Congressman FRENZEL. Yes.

Senator LONG. He insisted on offering an amendment which at one time we went along with here on this committee, to include Congress in the generality of that public financing concept of the $1 check-off.

When I agreed to go along with that amendment, one of my colleagues in the Senate came to me and said this: He said, Now, Russell, the way this thing stands now, you can be reelected without much opposition. And he said, I can be reelected with minimal opposition. And he said, if you help to pass this thing you are guaranteeing yourself a well-financed opponent and you are guaranteeing me one also.

Now as far as we individuals were concerned that made sense. Let me ask you this: Is that right for the public that we could sit up here and vote to say that we will maintain the status quo, which would mean that neither one of us are going to have opposition who have adequate financing to respond to what we can do just in terms of money?

Do you think that is right or fair? Is that good democracy?

Congressman FRENZEL. Yes.

Senator, I still believe in the market test of candidates. And every public financing bill that this House has considered during my short tenure in Congress has provided enough money so that you would have a contest, but that your opponent could not win, because they always set a maximum on what the challenger can spend, and that maximum is always about 50 percent of what the winning challenger, on average, had to spend in the last election.

So I have never seen a public financing bill that was not heavily proincumbent and, therefore, I don't look on that as being the answer to balancing the scales. I believe if you are a good candidate you will raise the money. You do in my State no matter what party you are.

Senator **Long**. As far as the President of the United States is concerned, we have finally got a law that helps to equalize. It doesn't balance it. But it is no longer a marketplace democracy. It is no longer a case of saying that the marketplace—I am talking about the money market—determines who the President is going to be. At least we have passed all of that foolishness. I don't know why we can't proceed along that idea to implement the idea of saying that people who have support among the public ought to have a relatively fair chance to be heard.

Congressman **Frenzel**. My judgment, Senator, is that Presidential candidates get a pretty good hearing whatever they are allowed to spend or not spend. And I suggest that some of the laws we have created may not have hurt, but some of them, particularly that relate to primaries and State-by-State limits, et cetera, have been inhibitive of I think participation and letting candidates make their story in giving people a free choice.

You suggested that we had solved the third party or the independent case. I don't think we have yet. And I am not sure that our tinkering in that regard has been an unrestrained success.

Senator **Long**. Mr. Chairman, may I just ask one more question?

The **Chairman**. One last question.

Senator **Long**. My thought here, Mr. Frenzel, is that we solved the third party problem as far as the Presidential campaign is concerned. And if we can do that logically, why couldn't we solve that problem with regard to Members of Congress?

Congressman **Frenzel**. Well all I can tell you is what political scientists say, that you have to establish a threshold for third party candidates or you get every dog and cat in the world. When you establish a threshold you don't know if you are keeping out only the dogs and cats or whether you are keeping out strong, legitimate candidates.

I would refer you to the FEC decision on Gene McCarthy, in New York, where it decided that he was not an independent candidate and could not qualify, in my judgment, a doubtful decision, and at least one that a lot of Americans criticized.

I think there are a lot of problems with that third party type candidate yet, and I think you can hear it from a lot of them who are out there trying to campaign.

The **Chairman**. Senator Pryor.

Senator **Pryor**. Thank you, Mr. Chairman.

I would like to turn from the contributions a moment to the Blue Cross issue if I might.

The **Chairman**. Let me, if we can. I want to finish with Congressman Frenzel first and then we will go on to both Mr. Tresnowski and Mr. MacDonald.

Senator **Pryor**. Well I think then under those circumstances I will pass and just wait and ask the Blue Cross people.

The **Chairman**. I appreciate it. Senator Heinz, you had a question of Congressman Frenzel?

Senator **Heinz**. Yes; Mr. Chairman.

First, it is good to see Bill Frenzel. He always has an opinion and once in a while they are right. [Laughter.]

But he always expresses them well.

One of the things that troubles me about the 100 percent tax credit is that we remove it in the name of increasing participation. If somebody makes a $100 contribution, they have, other than the waiting period, ultimately put up none of their own money.

Do you believe that the 100 percent tax credit is just an invitation on balance for people to participate in the political process for free or is it, as its proponents claim, a real invitation to political participation?

Congressman **Frenzel.** In my lifetime, Senator—and I have been running for office about a quarter of a century, less than many of you—I have never seen a political donor of a hundred bucks that only gave that money because of a tax incentive.

Senator **Heinz.** All right.

Congressman **Frenzel.** I have never seen one who would not make that contribution were there no tax incentive. I believe this is a prize you give them at the end of the year for having done something they already were going to do.

Senator **Heinz.** One subject that is extremely controversial—I would guess that there is a relatively small handful of Senators for it—is public financing of congressional and Senate campaigns for some of the reasons that have been discussed by you and others. But regardless of the merits of where anyone stands on that issue, is there a possibility that a $100 tax credit, a 100 percent tax credit on a $100, is in a sense an invitation to a back-door means of public financing as follows: You pass this, and then you then increase it to $250, and then say there is no need to permit individual contributions beyond $250? Or PAC contributions beyond $250. Wouldn't that, in effect, give us a system of public financing?

Congressman **Frenzel.** Most election proposals—in direct answer; yes. Most election proposals relating to public—to restrictions on tax, or at least political contributions, are all part of what I call a two-step process and the second step is public financing. All of them are aimed to make either contributions through PAC's undesirable or other kinds of contributions too much trouble, too expensive, and so that ultimately you go to the taxpayer.

Senator **Heinz.** Recently some of my colleagues were, I think, legitimately upset by some stories in the newspaper about the cost of mailing to their constituents in the Senate. We in the Senate are limited to 1½ sheets of paper for every voting age person in our State. And while there is a cost associated with that anywhere from, oh, 6 cents up to maybe 18 cents per voter, the House of Representatives can mail every single person at least six times, and therefore is at least three times more expensive than the Senate per constituent.

Doesn't the House, compared to the Senate, already have public financing of campaigns?

Congressman **Frenzel.** In a sense, we do, Senator. Although our first class——

Senator **Heinz.** Only if just for incumbents in the House?

Congressman **Frenzel.** Yes.

Our first-class mailing is worst than our mass mailings because we cannot mail everybody in our district an infinite number of times if we can find their address. And you know that we do find their addresses. And I wish that we had a rule like you did.

Our mailing cost in the House are unconscionable. Our gross mailing costs between the two Houses are going to run to about $160 million this year. We have appropriate $100 million. We will technically run out in mid-May. But since the post office sends us bills late, they probably won't come over until after election. But we have got a real problem. And there should be limits.

I think the Senate has taken a good first step. I wish the House would follow. I wish they would both be more restricted.

Senator **HEINZ**. So do we. I thank you, Congressman. [Laughter.]

The **CHAIRMAN**. Further questions of Congressman Frenzel?

[No response.]

The **CHAIRMAN**. If not, Bill, thank you very much.

Congressman **FRENZEL**. Thank you very much, Mr. Chairman and members of the committee.

The **CHAIRMAN**. Well, gentlemen, you have been very patient, and we appreciate. And we will start again on our early bird list with Senator Heinz first.

Senator **HEINZ**. Mr. Chairman, thank you.

Let me say to Mr. Tresnowski that I am impressed by the community actions that the Blues provide around the country. And I start with a strong predisposition to having the Blues retain their current tax status. The argument you have made, as I understand, is that you provide coverage to people who, if you did not provide them, whether they are high risk individuals, individuals, per se, small groups, nobody else would, and therefore you are, in a sense, loss leaders. You imply that the Blues are able to provide coverage, not only because they are not taxed but because you cross-subsidize to a certain extent. And if that is accurate, then, as policy, I am not offended by treating you as a charitable organization because you perform a public charitable function nondirected by Government, but charitable nonetheless. And that is your argument, in essence, as I understand it. Is it not?

Mr. **TRESNOWSKI**. That is correct.

Senator **HEINZ**. What would be helpful I think both to me and to the opponents of your position, and just generally to the members of the committee, is some information on what in fact the Blues do. For example, in each State do the Blues provide well-advertised extended open seasons for individual policies? What are the costs of those policies relative to other alternatives, if any? Are there limitations on the nature of the coverage? For example, can you have very basic benefit packages and no possibility for major medical? Are there waiting periods for preexisting conditions?

As you know, my staff has been working with your staff to obtain this information. I was wondering if you could tell us today what the status is. Will we have to wait a little longer or are you in a position to provide that information?

Mr. **TRESNOWSKI**. The information has been delivered to your staff in various parts. Of course, in the case of Pennsylvania, the record of the Blue Cross/Blue Shield plans are quite outstanding in the categories that you described in terms of open enrollments, individual coverages, taking on high risk individuals, limited underwriting regulations, and so on.

The Blue Cross and Blue Shield plans in Pennsylvania have been a good example of the delicate balance that I described. The tax

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exempt status sets in motion a series of events. It puts us in a category in the minds of the people. It puts us in a category in the minds of the doctors and hospitals of this country. It puts us in a category in the minds of those who buy our services in large industry. All of that taken together, supports the community service role all the Blue Cross and Blue Shield plans.

Senator HEINZ. Let me interrupt you at this point. I happen to agree with you about the present status in Pennsylvania. I think our Blue Cross/Blue Shield people have been extroardinarily responsive.

And my question really is: Is that as true in the other 49 States, and do we have the information to document that?

Mr. TRESNOWSKI. Yes. The information is available. It is quite variable. The States of New York, Maine, New Hampshire, Michigan, the Midwest, areas of the country where we have had greater opportunity to provide these services, the record is, of course, quite outstanding.

In other parts of the country where we enjoy less market share, less opportunity to negotiate with providers, the record varies somewhat.

But the overall philosophy of the Blue Cross and Blue Shield Plan is to write individual coverage.

Senator HEINZ. I understand that. But let me press you a little bit on this because whether or not Blue Cross/Blue Shield is successful in obtaining a market share of X or Y, that in a sense wouldn't be, I think, the most of us a rationale for letting you continue to have a charitable exemption from the Tax Code.

We are not so interested in whether you are successful as businesses as whether you are performing a public function.

So let me ask you informationally what percentage of Blue's group policies are experience-rated as opposed to community-rated?

Mr. TRESNOWSKI. None of the individual coverages are experienced-rated. They are all community-rated.

Senator HEINZ. My time has expired. I would like to return when I have a chance.

The CHAIRMAN. Senator Long.

Senator LONG. No questions, Mr. Chairman. Thank you.

The CHAIRMAN. Mr. Tresnowski, I share the opinion of Senator Heinz about Pennsylvania. I am very reluctant to step into the area of starting to tax the Blues with no hearings other than what we have had today. We did not consider this area of tax. I don't know how much the House considered it before they acted. Did you have hearings on it in the House?

Mr. TRESNOWSKI. None at all, Senator.

The CHAIRMAN. Well when we are talking about the breadth of coverage that the Blues have, and at least in my visual experience a very good success in Oregon—and I assume the other Senators seem to echo that—I am just reluctant to step into this when we don't know what we are doing and we don't know what the effect is going to be on a program that today has worked very, very well for the country.

Mr. TRESNOWSKI. I thank you very much.

The CHAIRMAN. I have no questions. Senator Chafee.

Senator CHAFEE. Thank you, Mr. Chairman.

Mr. Tresnowski, I believe that Rhode Island has the highest percentage of its population covered by Blue Cross of any State in the Nation.

Mr. **Tresnowski**. Intelligent people in Rhode Island, Senator.

Senator **Chafee**. We certainly are. I won't argue with that. I think that something like 83 percent of our population is covered by Blue Cross.

Mr. **Tresnowski**. Eighty-four.

Senator **Chafee**. Eighty-four? [Laughter.]

The problem here it seems to me is what do you do with the whole concept of mutual insurance? In other words, in our State We also have the Factory Mutual Insurance Co. In other words, a group of mill owners got together, and they said we will spread the risk by putting money into a common pool to insure our factories. At the end of the year if there have been no fires, well then the rates will go down. That is the whole concept of Mutual Insurance.

And yet over the years those companies have been taxed. Blue Cross and Blue Shield have not been taxed because, as you point out, they return the benefits to the individuals. What is your strongest argument for tax exemption? Is it that you take on risks that, say, Mutual of Omaha would not undertake? Give us your best argument for your case.

Mr. **Tresnowski**. The argument is the evidence that is before us in the business practices of the mutual insurance companies, the Prudential, the Equitable, all mutual insurance companies. Prudential announced 2 years ago that it was getting out of the individual health insurance market because they couldn't stand the losses they were taking.

Mutual insurance companies move into markets, take risks, find that the risks turn bad on them and they move out of them.

Blue Cross and Blue Shield plans—and Rhode Island particularly is a very good example of this—have sustained themselves over a long period of time, and at the same time provided coverage for high risk individuals, have never left that market at any time. Plans provide coverage for small groups, the grocery store, the gas station, people who cannot get health insurance coverage because they are groups of two and three and five. Their risks are high.

Blue Cross and Blue Shield plans have staying power. They are a product of those communities. They reflect the community interest and they are really quite different than mutual insurance companies in that sense.

Senator **Chafee**. Do you think that the exemption should be contingent upon Blue Cross making that commitment for the future?

Mr. **Tresnowski**. It depends on how that contingency is asserted. I would be personally concerned about a Federal law that would establish a standard. A standard tends to strike at the lowest common denominator.

Senator Baucus was here earlier this morning. He authored an excellent bill on Medicare supplementary coverage. And in that bill he put a standard in of a 60 percent loss ratio for Medicare complimentary coverage. Well 60 percent is no standard at all. We write that business at 85 percent loss ratios. And when you establish federal standards to apply to local community situations that are so variable across the country, the tendency will be to drive it down to the lowest common denominator. And I think that would be quite unfortunate.

Senator CHAFEE. Well the chairman mentioned that he would be reluctant to get into this field. I am reluctant too, and not solely because 84 percent of my State is involved.

Senator HEINZ. It is now 85. [Laughter.]

Senator CHAFEE. I did take note of that statistic.

Certainly before we get any further into this, Mr. Chairman, I think we ought to know what we are doing and what the consequences are. We may need more than an hour and a half hearing from one witness. Thank you, Mr. Tresnowski.

The CHAIRMAN. Senator Durenberger.

Senator DURENBERGER. What is my percentage in Minnesota?

Mr. TRESNOWSKI. It is not 84.

Senator DURENBERGER. Oh.

As usual, I agree with the chairman's good judgment in this field, everything except his judgment on employer-paid hospital accesses. But that is not to say that we shouldn't visit this issue.

When I came in here Jack Heinz was asking Ambassador Samuels on the issue of subsidies, and it strikes me that as I listened to your testimony and I look at the reality of what is going on out there, we are subsidizing a variety of services, services to high risk individuals, services to individuals, services to people who need conversion into small groups. And this tax subsidy is a clear subsidy. And I would argue that there might be better ways to subsidize it than by putting it inside a policy that may vary from State to State, community to community, company to company.

So I just say that because I think it is appropriate to take a look at this issue and find out if this is the best way to solve the problem. But it certainly is unfair to take Blue Cross and Blue Shield just because it has always been the leader in providing insured coverage for people in this country to say that you are going to be the first to lose your subsidy.

Obviously, the people that came along later, like the rise of self-insured plans, they have got a similiar subsidy. Most of the prepaid plans, the HMO's in particular, have subsidies.

I come from a State in which you cannot have a for-profit HMO, so everybody is nonprofit and nobody can be taxed. And the HMO's, as you know, are taking business away from everybody. Blue Cross is going into the HMO business.

So the playing field is so unlevel out there that it seems to me the chairman is absolutely correct in saying it really is unfair without more hearings to pick on one part, and particularly one of the more creative parts of this. But that is not to say that I don't think, Mr. Chairman, and my colleagues, that over the next couple of years, as we address the issue of subsidies and particularly in the Tax Code that we might not want to look at the way in which a tax policy is used to sort of unlevel the playing field across the country. And I don't think any of us have come to any conclusions about the appropriateness of taxing everybody or not taxing everybody, but certainly I support your position, Mr. Chairman, with regard to this particular provision in the House bill.

The CHAIRMAN. I thank my good friend, Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, I would like to speak to Mr. MacDonald's very comparable set of concerns and I will start by asking the proposal to make TIAA-CREF a taxable entity, that was not in the President's legislation, was it?

Mr. MACDONALD. No, sir.

Senator MOYNIHAN. It was not. Were hearings held in the Committee on Ways and Means in this matter?

Mr. MACDONALD. No, we did not have an opportunity.

Senator MOYNIHAN. Mr. Chairman, here we have a program that has been in place for 60 years and more.

Mr. MACDONALD. Sixty-five.

Senator MOYNIHAN. Sixty-five. It covers 1 million persons in higher education. It has lived quietly and well and bothered no one and provided a great service to American universities, which is that it has allowed people to move between institutions with portable pensions that we have been talking about so widely. And with no hearing, with no warning, no support from the administration. They suddenly propose to make this a taxable entity.

You could restructure as I take it in such a way that you would become, in effect, a pension plan, and therefore not be taxable. But that would involve rewriting contracts with a million persons, would it not?

Mr. MACDONALD. Yes, sir. Whether it is possible from a practical point of view, I am not sure. But from a theoretical point of view, yes, sir.

Senator MOYNIHAN. In theory, you could be a pension plan and completely exempt from tax.

Mr. MACDONALD. Yes, sir.

Senator MOYNIHAN. That would simply require a negotiation with 1 million professors.

Mr. MACDONALD Yes, sir.

Senator MOYNIHAN. And this is being put on you with no prior notice, no advocacy from the Treasury, no hearings.

[Whereupon, the electricity went off in the hearing room.]

Senator MOYNIHAN. I was saying as the lights went off that the TIAA-CREF was a tax shelter.

The CHAIRMAN. Yes. I think this is more likely because we are about to tax parsonages. [Laughter.]

Senator Bradley.

Senator BRADLEY. No questions, Mr. Chairman.

The CHAIRMAN. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, if I could say that it is my very clear understanding that the House Ways and Means has a staff proposal that there was no real attention given it by the full committee, no hearings, no proposals from the administration, and it is an astonishing measure. And obviously if there is any revenue to be gotten for the Treasury, TIAA can avoid them. I mean, if anything can explain the attention by this arrangement they would not be taxable. There just doesn't appear to be an interest here for an arrangement that for 65 years have been singular for American education, and for what purpose I cannot understand.

It is true that you do sell some disability insurance and some life insurance.

Mr. MACDONALD. Yes, sir.

Senator Moynihan. For what portion of your——

Mr. MacDonald. Well that would be about 1 percent of the combined assets that are in reserves standing behind the insurances.

Senator Moynihan. About 1 percent?

Mr. MacDonald. Yes, sir.

Senator Moynihan. Is it possible that if some legislation were worked out that would in fact make it appear to be comparable to other insurance activities and could be taxable? Could that be——

Mr. MacDonald. Yes, sir. We have not opposed that provision that would tax the insurances. It is only the provision that would tax the annuities.

Senator Moynihan. Mr. Chairman, did you hear what Mr. MacDonald said? They are not opposed to equal treatment for equal behavior. But they have to be treated as if they were a pension system when they are a pension system with respect to 99 percent of their customers. What do you think?

The Chairman. I think the point is well taken.

Senator Moynihan. I think that the proposal to treat the Blues the way we do here has no basis insofar as this committee is concerned. I think this is clear, sir. And this should be treatment that the TIAA-CREF have to check. It is tough financing. It works. It involves a million people's lives, a million policyholders and their families. And for what purpose? What do they think they are making in the way of money coming in? Do they ever tell you?

Mr. MacDonald. Well I think the staff had estimated $80 million a year.

Senator Moynihan. $80 million?

Mr. MacDonald. Yes, sir.

Senator Moynihan. Well for $80 million we are going to wreck one of the most stable pension systems in our community and one fundamental toward higher education.

Mr. Chairman, the lights are not working. I think my yellow light would be on by now, but I——[Laughter.]

I hope I made a good point there. Just in the interest of full disclosure, I can tell you I am going to come into a solid $9,000 a year annuity with TIAA-CREF. But it might drop below $9,000, but even so, I think this is a poor proposal. No hearings. No backing. No support from the Congress. Just another example of why that bill is 1,300 pages long and nobody knows what is in it.

The Chairman. Senator Bradley.

Senator Bradley. No questions, Mr. Chairman.

The Chairman. Senator Pryor.

Senator Pryor. Thank you, Mr. Chairman.

First, on the Blue Cross issue, how much would you have to raise the premiums if the Blue Cross/Blue Shield were not exempt from taxation?

Mr. Tresnowski. That is a difficult question to answer because it depends on what the chain reaction of events are and the results of taxation. Let me describe it this way for you.

The tax itself would trigger some events in the States, including greater argument in support of State premium taxes. It would also trigger a different attitude by hospitals and doctors who give us differentials now for the nature of the business practices we perform.

All of that taken together makes for very, very substantial amounts of money that help finance the individual coverage and the high risks.

The tax exemption itself would amount to a 7-percent increase. But you add up premium taxes in the States and you add up the loss of the differential, the loss of the opportunity, the subsidy by large groups, and you could be talking about 30- and 40-percent rate increases for these individuals.

Senator PRYOR. For the State of Arkansas, if my figures are correct, it is second only to the State of Florida in the percentage of its population over 60.

What effect would the removal of the tax exemption of Blue Cross/Blue Shield be on the elderly population; more specifically, those subscribers who are enrolled in the Medipac Program? What effect would this have?

Mr. TRESNOWSKI. The effects would be as I have just described. It would hit heaviest on the elderly because they are individual subscribers in Medicare complimentary coverage, Medipac in the case of Arkansas.

They are the most vulnerable groups in our society. The increases would range anywhere from 10 to 15, up to 35 percent.

Senator PRYOR. Have you done any study on what effect it would have if the individual elderly citizens because of the tax and the rate structure being changed upward, what effect that might have on them leaving the program thus causing an increased pressure on the Medicare Program?

Mr. TRESNOWSKI. In my prepared statement we used a hypothetical example of the people who would be lost. We picked 550,000 of the 11 million, assuming that would be the group that would be lost. We used a very conservative number of $1,600 as the annual cost per individual, and you are up to close to a billion dollars a year as contrasted with the estimate in the House bill of $1.7 billion over 5 years.

Now assuming that half of that turns to the Government, you are talking about far more money being channeled back to the Government in coverage to people who could not afford it.

Senator PRYOR. If I might now, I would like to ask Mr. Tresnowski—I would just like to share the viewpoints expressed by the distinguished chairman of the committee and the distinguished Senator from New York, and others, relative to the lack of hearings on this issue. And I think that we are treading on very thin ice in attempting to go back and to remove the tax exempt status for Blue Cross/Blue Shield.

Now, Mr. MacDonald, I have an older brother who is a Presbyterian minister. Of the two Pryor boys, he is the one that they say makes an honest living. [Laughter.]

He told me the other night that he was deeply concerned about the pension changes. Is it possible that ministers are also—I know that the Senator from New York is concerned about the professors and many of his colleagues, I am sure—but aren't there many, many ministers involved in this program?

Mr. MACDONALD. It is clear that this bill covers the college and university plans, because it mentions TIAA-CREF by name. My understanding is that the church groups that have somewhat similar arrangements are also very concerned. But I am really not privy to that.

Senator PRYOR. I see.

Mr. MACDONALD. I think their status is unclear.

Senator PRYOR. Well there is a growing perception, I think, among the clergy that many of those who are involved in this program will suffer a fairly severe tax load which has not been true in the past.

Senator MOYNIHAN. That's right.

Senator PRYOR. I think that is correct, but I am not certain. I think it is.

Senator MOYNIHAN. That is how we read the bill.

Senator PRYOR. Now once again, was there any hearing on this issue in the House of Representatives before H.R. 3838?

Mr. MACDONALD. No, sir.

Senator PRYOR. There was no hearings?

Mr. MACDONALD. No, sir.

Senator PRYOR. And your organization was not contacted as to what was going to happen? What sort of advance warning did you receive?

Mr. MACDONALD. Well, we had very little advance warning. When it came up in a staff report was the first time that we saw indications of it. I saw the actual wording and provisions that came out, after it was passed.

Senator PRYOR. I thank you very much.

Mr. MACDONALD. Thank you, sir.

Senator PRYOR. Thank you, Mr. Chairman.

The CHAIRMAN. Senator Heinz.

Senator HEINZ. Mr. Chairman, we were talking a minute ago about the experience rating and the community rating of Blue Cross policies, and in answer to my question, what percentage of Blue's group policies were experienced rated, you answered that all individual policies were community rated. And I understand the latter, and that is commendable, although I have a question about that. To what extent are group policies community rated?

Mr. TRESNOWSKI. The groups, above about a hundred employees, are experienced rated. Those are the larger groups. Groups below about a hundred are community rated.

Senator HEINZ. And is that a fairly hard and fast rule in all States?

Mr. TRESNOWSKI. No. In some States the group size varies. It could go up to a group of 200 and below that would be community rated. But generally we do not experience rate below a hundred.

Senator HEINZ. Now critics of your tax exemption—and, as I say, I am not one of those—contend that although the Blue's community rate all the individual plans, that almost by definition the—it is in fact an experienced rated group of people who are all relatively high risk individuals. You didn't plan it that way. It just turned out that way. And, therefore, what is, by every normal measure, a community rated group in fact is an experienced rated group with prices reflecting that in coverage—in more limited coverage also reflecting that. How do you answer that criticism?

Mr. TRESNOWSKI. You answer it with the evidence on the average across the country our loss ratios on that business is 88 percent.

Senator HEINZ. Now what does that mean?

Mr. TRESNOWSKI. That neans that we return 88 cents of every dollar in premium in benefits.

Senator HEINZ. How does that compare to your other——

Mr. TRESNOWSKI. Competitors? They return 54 cents for every dollar of premium.

Senator HEINZ. And what do you return on your group policies of more than 100?

Mr. TRESNOWSKI. The pay out ratio on group policies of more than 100 employees is more like 92 percent, 92 cents on every dollar.

Senator HEINZ. 92 cents?

Mr. TRESNOWSKI. I would also point out that—although you have described individuals as an experienced rated group unto themselves, the experience is looked at. But there are subsidies to those groups taken from a variety of sources. The tax-exempt status, of course, being one; the differentials that we achieve from hospitals and doctors who recognize that if we did not cover those individuals they would wind up as bad debts or uncompensated care being another.

Also, our large groups have been generally willing to a lesser extent today, but willing to contribute small amounts of money to the enrollment of those high risk groups with the understanding that if they did not, they would be paying for them anyway through uncompensated care to the hospitals.

So although experience rated, they are subsidized in a variety of ways.

Senator HEINZ. Now what about the problems of high risk individuals. There are individuals who simply cannot get insurance for them at a reasonable rate because they have preexisting conditions.

Now is it my understanding that some States are turning to risk pools. Some eight States now have such pools to help those people.

Is it too much to expect the Blues to do that? Is that an unreasonable assumption of charitable functions? Or is it just impossible for the Blues to attend to those high risk individuals where we see more risk pools being created in States to accommodate them?

Mr. TRESNOWSKI. I don't think you will see more risk pools. The eight pools that you described have only 20,000 people enrolled in them. The problems of high risk pools is that you put all the bad risks in one pool, and you have made the rate almost unaffordable for anybody.

I was surprised, Senator Heinz, when we began to look at and do an analysis of this information ourselves at the plans who conduct open enrollments without recognition of medical condition. A person with cancer in the city of Washington, DC, could walk in in the 30-day enrollment period here and enroll and get coverage on their way to the hospital. And Washington, DC, is not atypical; Pennsylvania also New York. Many parts of the country do that.

Our concern with the risk pool is twofold. One, if you have a risk pool, what happens is that Blue Cross and Blue Shield gets double dipped. We continue to take on high risks and plus we have to contribute to a risk pool where all the commercial insurance companies would have an advantage over us.

The second is that it provides an incentive for the commercial insurance industry to back away completely from any coverage of any kind of risk at all. And we think that that is just basically wrong.

Senator HEINZ. Mr. Chairman, I have some additional questions I would like to submit in writing. I understand the difficulty Mr. Tresnowski or any of us would face in coming up with information on each of the 50 States with some specificity.

And I think that we should view this discussion today as a good opportunity to put on the record the, what at least in my home State of Pennsylvania, is an outstanding job by Blue Cross and Blue Shield. I have one other brief question, if I may, Mr. Chairman, which is this: Let's assume, wrongly I hope, that we find that there is enormous variability between the States on what Blue Cross in fact does do for individuals who are high risk people in terms of open enrollment and so on. And that you and I as reasonable people might agree that on balance Blue Cross in some areas, some States, could do a good deal more than they are doing, and still be viable.

What is there that we should consider to encourage you—and I am sensitive to your concern about setting any standards, because they are rigid and can be counterproductive—what is there that we can or should do that would help improve the performance of those hypothetical Blues but might be doing as good a job as you or I might want them to?

Mr. TRESNOWSKI. I think, Senator Heinz, the answer is clear. Retain the tax-exempt status of Blue Cross/Blue Shield.

Senator HEINZ. Well we have been doing that. We have been doing that.

Mr. TRESNOWSKI. But the visibility associated with the provision in the House bill, and this hearing, would be very sufficient, in my judgment, to attract the attention of those who may not be totally committed.

Senator HEINZ. So you are saying it is wake up time?

Mr. TRESNOWSKI. Yes.

Senator HEINZ. And you are going to make sure that everybody knows the alarm clock went off.

Mr. TRESNOWSKI. That's right.

Senator HEINZ. Thank you very much.

Senator CHAFEE. Senator Grassley.

Senator GRASSLEY. I would only ask—First of all, let me say I did not hear your testimony when I was here because I was chairing another subcommittee meeting, and so I have not had a chance to read it, which I am going to do. But have you looked at how the taxation in the House plan 3838 impacts upon members at different income levels for your people so that you know to what extent it impacts upon low-income people, middle-income people, versus high-income people?

Mr. TRESNOWSKI. The only surmise we can make on that is that we believe that it is going to hit hardest individuals, those who buy their Blue Cross and Blue Shield as individual coverage, the elderly primarily because they buy on an individual basis, and high risk individuals who cannot get coverage anywhere else.

Our judgment is that—we have never done a cross comparison on an income basis—but our judgment would be that most of those groups would be people of lower income status.

Senator GRASSLEY. I am sorry. I was looking at the wrong person. My question was about TIAA-CREF. I am sorry.

Mr. TRESNOWSKI. Did you like my answer? [Laughter.]

Senator GRASSLEY. No. Except——

Mr. MACDONALD. The actual tax would apply quite even-handedly across everyone relative to their participation in the system; $80 million might roughly equate to half of 1 percent, say, in interest earnings, which might not seem like a very large amount. But for someone for whom contributions into an annuity have been made for 30 years and having that compound and grow, it could mean starting benefits for someone after 30 years of maybe 10 to 12 percent less than they otherwise would receive.

Now to the extent that an individual is near the margin of what he needs, it would hurt more to lose 10 percent than if the person were more affluent. This is the best I could answer the question.

Senator GRASSLEY. Thank you.

In regard to Blue Cross/Blue Shield, I assume that any taxes imposed—and this is getting back to what you would have answered, I'm sure, but just to see if I am on the right track—because of such a large payout, a high percentage of payout of the premiums paid in, which maybe you want to give me that percentage, but it would be almost a direct passthrough I assume. Right?

Mr. TRESNOWSKI. What would be? You mean the tax?

Senator GRASSLEY. Yes, the tax.

Mr. TRESNOWSKI. Well, no, the tax would not be. It would fall unevenly across the various groups. And the point that I am making is that it would fall heaviest on the individual and the elderly group—the 11 million people that buy their own coverage—primarily because in the large group market, the market is so competitive. Since it is competitive around the retention that we charge, we would probably not put the tax there. It would have to fall to the individual market.

Senator GRASSLEY. Thank you, Mr. Chairman.

Senator CHAFEE. Thank you.

When we started out on this tax reform we had two objectives: simplicity and fairness. Now simplicity has been jettisoned, but there still is a struggle for fairness. We all know that life isn't completely fair, but it seems to me that the goal of this committee still ought to be to struggle toward the goal of fairness.

So let's take the TIAA today for a minute. As I understand it, if you were set up as pension funds, there would be no tax on the entity at all. Is that correct?

Mr. MACDONALD. That is correct. Yes, sir.

Senator CHAFEE. We have been getting scores of letters on this matter, obviously, as have other offices. Somehow the suggestion has gone out—it seems to me incorrectly—that a tax is going to be imposed on the annuitants themselves, which is not the case. Am I right, Mr. MacDonald?

Mr. MACDONALD. Well——

Senator CHAFEE. The tax here is not on the annuitant. It is on the entity. Is that correct?

Mr. MacDonald. Well, the tax would be on the funds that those annuitants are putting aside for their retirement. So, it would come right out of their funds, sir.

Senator Chafee. They are not going to have an individual tax burden--am I correct? I just want to get this correct because some of the letters that we have received indicate that they are worried they are going to have start paying a tax bill.

Mr. MacDonald. Well, they will not be paying additional tax on their own individual tax returns.

Senator Chafee. Why is it that your structure is such that pension funds not being taxable, somehow you are caught? What have you got there?

Mr. MacDonald. It goes back a bit in history. TIAA predated almost all pensions in the United States and was created before any full legislation was enacted in the 1940's dealing with the tax treatment of pension funds. CREF was much the same thing, CREF was the first variable annuity in the world. It was invented by TIAA and CREF. There was no provision at that time for separate accounts of a life insurance company which would have been the place that CREF would have gone, had there been such an ability to do so; but that did not exist. So, CREF was created as a new nonprofit membership corporation in New York. So, it predated separate accounts.

Then the question comes: All right, well, why not now make CREF a separate account?

Senator Chafee. I understood the exchange you had with Senator Moynihan on that.

Mr. MacDonald. Yes.

Senator Chafee. Apparently it involves going to a million professors, which is difficult in itself.

Mr. MacDonald. But it would create no tax, which was what was my——

Senator Chafee. Yes. So, as you pointed out with Senator Moynihan in your exchange, in the best of worlds you could set it up so it would be nontaxable. So, I think we can pierce the corporate veil, as it were here, and see that this is like a regular pension fund and shouldn't be taxed. Now, you did mention that there was some aspect of it that was insurance that you thought should be taxed. Well, you are not encouraging it, but you are not resisting it quite as much. Is that true?

Mr. MacDonald. That is true, Senator. There is not the long history of public policy with respect to not taxing insurances that there is with respect to not taxing pension funds until they are received as benefits by the individual. And so, it would be a change. We have appreciated that tax exemption. When we started major medical insurance and disability insurance with the help of a Ford Foundation grant in the 1950's and 1960's, we made coverage available that was not available to the colleges. We wrote that coverage almost exclusively over Blue Cross at that time, which other insurance companies would not have done—were not willing to do. Blue Cross did not write major medical then.

Senator Chafee. My time is up; and I have got another question, but it is Senator Moynihan's turn now.

Senator MOYNIHAN. Mr. Chairman, why don't you go ahead and ask your question?

Senator CHAFEE. All right. This goes to Mr. Tresnowski. Here is the problem—again struggling with this concept of fairness. The Blue Cross has been in a competitive position in bidding for various CHAMPUS contracts and has been successful. Now, what do we say when Mutual of Omaha comes by and says: Now, we bid for CHAMPUS. You bid for CHAMPUS. Yet, you are not paying an income tax, and we are. I can understand your argument about coverage for the small groups such as filling stations and the high risk individuals, but what do we do with a bulk contract like that?

Mr. TRESNOWSKI. Senator Chafee, I am intimately familiar with the CHAMPUS bids, and I would suggest that Mutual of Omaha lost those bids not on the basis of any tax-exempt advantage we have. The margin of difference in the bid prices were very substantial, related largely to the efficiency of the computer operation of Blue Cross and Blue Shield, and particularly Rhode Island, which is a major winner of the CHAMPUS contract.

The CHAMPUS contract is not an underwritten contract. It is an administrative services only for the use of our computers to process claims for beneficiaries of the CHAMPUS program. The bid difference had nothing to do with the tax-exempt status.

Senator CHAFEE. We have to fight off those who are your competitors. Let me ask you this: Do you feel that in a CHAMPUS bid, those virtues of Blue Cross, which were outlined earlier, pertained to a CHAMPUS bid as well? Are the same factors involved?

Mr. TRESNOWSKI. I think it does in this sense——

Senator CHAFEE. In other words, is the broad service covering the individual and so forth relevant in a CHAMPUS bid?

Mr. TRESNOWSKI. I think it does in this sense: Why do we go after a CHAMPUS contract? We go after it because it shares in the overhead of all the business that we do. A computer is in place to serve all our lines of business. If we can put a piece of the cost of the computer on the CHAMPUS contract, it helps to support all of our lines of business. To the extent that it helps to support all of our lines of business, we are then better able to return, as I said, 89 cents on every dollar in benefits to the individual and high-risk groups. So, the acquisition of the CHAMPUS contract indirectly helps us do the kinds of community service responsibilities that I described earlier.

Senator CHAFEE. All right, fine. Thank you very much. Senator Moynihan?

Senator MOYNIHAN. Mr. Chairman, we have other witnesses.

Senator CHAFEE. We do.

Senator MOYNIHAN. I don't want to go on too much further, but I would like to make two points and ask Mr. MacDonald if there are any further points he would like to make. The first is that it is our understanding that the Unitarian Church, the Presbyterian Church—or should I say the Unitarian persuasion and the Presbyterian Church—have set up systems comparable to the TIAA and that the law, as it is now written, could extend to them. Is that your understanding?

Mr. MACDONALD. That is my understanding, sir.

Senator MOYNIHAN. Yes. So, Mr. Chairman, we would put in jeopardy—excuse me—we would be putting in jeopardy these annuity systems that these three mentioned religious groups have put in as well.

Senator CHAFEE. Oh, yes.

Senator MOYNIHAN. And the other thing to say is simply—Mr. MacDonald, if you would make it clear—when persons meant to receive their retirement benefits under TIAA, CREF, they proceed to pay taxes on them?

Mr. MACDONALD. Yes, sir.

Senator MOYNIHAN. There is no avoidance of taxation by the individual. Every penny that they get is taxable, as you would expect. It is just that this nonprofit organization has made available and pooled the resources of some 3,600 institutions, not all of them but most of them teaching institutions, but not invariably; and they are all nonprofit.

Mr. MACDONALD. And all educational organizations. And that is absolutely right, Senator. Annuitants who are receiving benefits from TIAA-CREF will pay taxes on those benefits just as annuitants from every other pension system and fund will pay taxes on those benefits when they receive them. It is a question of taxes being imposed before the benefits are paid out to individuals.

Senator MOYNIHAN. Could I then just ask you if I sum up correctly that you are in every essential respect a pension fund?

Mr. MACDONALD. Yes.

Senator MOYNIHAN. And no other pension fund pays taxes in the country and this law would require you to do it?

Mr. MACDONALD. Yes, sir.

Senator MOYNIHAN. And as a pension fund, you pay out to retired persons, and they pay taxes on what they receive?

Mr. MACDONALD. Yes.

Senator MOYNIHAN. As with every other pension fund?

Mr. MACDONALD. I think it is what we have tried to point out in the testimony, that this really does single out the colleges and universities pension system for really unfair treatment, vis-a-vis others.

Senator MOYNIHAN. Well, that is the point that Senator Chafee was trying to make about fairness. This would make—what would you estimate would be reduction in retirement benefits if this were required?

Mr. MACDONALD. I tried to answer that question a little bit before——

Senator MOYNIHAN. Yes, Senator Grassley was asking.

Mr. MACDONALD. For someone that was in for a period of over 30 years. For those that are close to retirement, it would make a very modest difference, you know.

Senator MOYNIHAN. But over time?

Mr. MACDONALD. For those that were in for 10, 20, 30, and 40 years and of course, that is the kind of commitments that there are with TIAA-CREF—they run 50 and 60 years, and the difference can be very significant. When you are talking about 30 years of contributing, the reduction is probably in the area of 10 to 12 percent if you——

Senator MOYNIHAN. That is my point, Mr. Chairman. We are proposing here to reduce the pensions of retired academics by 10 to 12 percent in a manner that no other pension fund is experiencing whatever. It is not fair. It makes no sense, and it should never have happened in the first place. And we thank you, Mr. MacDonald, and thank you, sir.

Mr. MACDONALD. Thank you, sir.

Senator CHAFEE. Senator Grassley.

Senator GRASSLEY. No questions, Mr. Chairman.

Senator CHAFEE. Gentlemen, let me say as far as I am concerned, I don't want to see any tax on the annuities of professors or teachers or ministers. I think that the point that Senator Moynihan made is a good one. Somehow through a peculiar arrangement, although you are doing just what a pension fund does, somehow there is a suggestion a tax be levied. I certainly wouldn't support that myself. As far as the Blue Cross goes, in my State you have done a superb job and we are very grateful for what you have done up there and the coverage you provide. Also, we are grateful that you have won those CHAMPUS contracts which extend way out beyond our district. I think that is beyond our State, beyond our area. They have been good for the State and good for Blue Cross. So, we are glad you came. Thank you very much.

Now, we will have a panel of Mr. Langdon, Mr. Wiacek, and Mr. Loree. Now, the tilt of this panel is on foreign taxation matters, I gather; and Mr. Langdon, why don't you go right ahead? We welcome you.

STATEMENT OF LARRY R. LANGDON, DIRECTOR OF TAXATION, HEWLETT-PACKARD CO., PALO ALTO, CA; ON BEHALF OF THE AMERICAN ELECTRONICS ASSOCIATION

Mr. LANGDON. Thank you, Mr. Chairman and committee members. I am Larry R. Langdon, director of tax and distribution of Hewlett-Packard Co., Palo Alto, CA. Hewlett-Packard is a designer and manufacturer of more than 10,000 measurement and computational products and systems. In the last fiscal year, the Hewlett-Packard Co. and its subsidiaries had sales of $6.5 billion, about 43 percent of which were to customers outside the United States.

Senator CHAFEE. How much was that percentage?

Mr. LANGDON. Forty-three percent were sales outside the United States.

Senator CHAFEE. Goodness gracious. Now, is that in dollar volume?

Mr. LANGDON. Yes.

Senator CHAFEE. Wow. Thank you.

Mr. LANGDON. Hewlett-Packard has over 84,000 employees worldwide, of whom about 56,000 work in the United States. Hewlett-Packard's worldwide R&D expenditures last year were $685 million, 92 percent of which were in the United States.

I am appearing before you this morning on behalf of the American Electronics Association, the largest trade association of this Nation's largest manufacturing industry, which employs about 2.5 million workers nationwide. The AEA written statement covers a number of issues, and I am specifically regarding the AEA's strong opposition to the provisions of H.R. 3838 which require that royalties and other similar payments for technology transferred to foreign affiliates be measured not by traditional arm's length standards but by the level of net profits of the affiliate, taking into account variations from year to year.

The U.S. Tax Code has long required under section 482 that dealings between related parties generally, including U.S. companies and their foreign affiliates, be conducted on an arm's-length basis, as if those dealings were between unrelated parties. Most major developed countries have this same principle incorporated into their Tax Codes. Thus, under U.S. law for U.S. companies licensing technology to a foreign affiliate, that affiliate must agree to make royalty payments to the parent in a manner consistent with that that an unrelated party would pay for the transfer of the same technology under the same terms and conditions.

We oppose the House change for four reasons First, the House provisions undermine the meshing of international tax regimes. The United States has long been a leading advocate of the use of the arm's length standard to resolve international taxing disputes. Through the U.S. model tax treaty, the OECD model tax treaty, and specific U.S. bilateral tax treaty negotiations, the United States has been instrumental in persuading other nations to accept the arm's length standard. To amend this standard now would seriously undermine these long-standing efforts. Second, the provision would create international double taxation. Because foreign governments would not adopt the proposed U.S. rule for their local tax purposes, U.S. companies will face the prospect of double taxation on at least some of their profits from foreign manufacturing. The United States would in effect force U.S.-owned foreign affiliates to make royalty payments which, for foreign tax purposes, are treated as nondeductible dividends.

Moreover, the increased royalty payments to the United States, unlike dividend payments, will not bring along any foreign taxes, in fact paid, to offset U.S. tax on that income. Third, the provision would create continuous IRS taxpayer disputes and lead to a cost-plus allocation of manufacturing income. While the House proposal specifically abandons the use of the arm's length standard in determining related party royalties, it gives little guidance of what alternative principles or rules taxpayers would have to apply to determine proper royalty payments under the new provision. The statutory committee report statement that any royalties should be commensurate with the income attributable to the intangible, begs the question of how to determine the amount attributable to that intangible. Fourth, the changes to present law are unnecessary. Most U.S. multinational companies have international licensing agreements similar to Hewlett-Packard's: Longstanding licensing arrangements covering all future products at a single royalty percentage rate applied to sales revenue. These agreements have been reviewed and approved by the United States and foreign governments over the years. They accomplish a reasonable division of profits between taxing jurisdictions and lead to relatively few disputes. Surely, such facts cannot be seen as giving rise to the kind of abuses that require abandoning traditional arm's length norms in the U.S. legislation.

For all of the above reasons——

Senator CHAFEE. Now, what page are you on here?

Mr. LANGDON. I am on my conclusion.

Senator CHAFEE. All right, fine.

Mr. LANGDON. For all the reasons stated above, the abandonment of well-established international taxing norms, the potential for international double taxation, the likelihood for continuous disputes with the IRS, and the failure to identify any abuses which cannot be prevented under present law, we strongly urge that the Senate reject the House changes to section 482 or section 367(d) with respect to foreign affiliate royalties. I am prepared to answer any questions you may have. Thank you.

Senator CHAFEE. Thank you very much, Mr. Langdon.

Now, Mr. Wiacek?

[The prepared written statement of Mr. Langdon follows:]

Statement of Larry R. Langdon
Director of Tax and Distribution,
Hewlett-Packard Company
for the American Electronics Association

Mr. Chairman, and members of this distinguished Committee, my name is Larry R. Langdon. I am the Director of Tax and Distribution of Hewlett-Packard Company, headquartered in Palo Alto, California.

Hewlett-Packard is a designer and manufacturer of more than 10,000 measurement and computation products and systems. During its last fiscal year, Hewlett-Packard Company and its subsidiaries had sales of $6.5 billion, about 43% of which were to customers outside of the United States. Hewlett-Packard has over 84,000 employees worldwide, of whom about 56,000 work in the United States. We currently employ over 2,500 people in your own state of Oregon. Worldwide R&D expenditures last year were $685 million, 92% of which were in the United States.

Description of AEA

I am appearing before you this morning on behalf of the American Electronics Association.

AEA is the largest trade association of this nation's largest manufacturing industry. AEA represents over 2,900 member companies nationwide, and over 450 financial, legal and accounting organizations which participate as associate members. AEA encompasses all segments of the electronics industries including manufacturers and suppliers of computers and peripherals, semiconductors and other components, defense systems and products, telecommunications equipment, instruments, software, research, and office systems.

The AEA membership includes companies of all sizes from "start-ups" to the largest companies in industry. Although 79% of our member firms are small businesses, employing fewer than 300 people, AEA also represents two-thirds of all the large electronics companies in the U.S. with over 1,000 employees.

Before addressing the committee's specific questions concerning the treatment of foreign affiliate royalties under Section 482, I would like to place our concerns with that provision in their proper context as one factor in the international competitiveness of the U.S. industry overall, and high technology electronics in particular.

The Role of High Technology in the U.S. Economy

A recent Commerce Department study concluded that:

> High technology industries are vital to the U.S. economy. Their growth rate has been

> twice that of total industrial output, and they contribute the bulk of technological advances to all sectors of the economy.
>
> National security depends upon the technology-intensive industries both for sophisticated items essential to modern weapons superiority, and for a strong and flexible industrial capacity for future contingencies.
>
> The United States will have to depend heavily on its areas of greatest strength -- principally advanced technology -- to meet increased competition in world markets. 1/

Vital as these electronics industries are for their contributions to innovation, productivity, national security and our quality of life, two important facts about them are not widely recognized. First, they have become very large in their own right, and second, they are rapidly losing their leadership position in world markets.

The Nation's Largest Manufacturing Industry

As a direct result of the enlightened capital gains policies of the last seven years the U.S. electronics industry has created over one million new domestic jobs and become the nation's largest manufacturing industry, now employing over es+teyppyar serylcr.s Policies which impact this industry therefore have a substantial direct impact on this nation's

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1/ An Assessment of U.S. Competitiveness in High Technology Industries; International Trade Administration; U.S. Department of Commerce; February 1983; pg. iii.

manufacturing sector. But such policies also indirectly affect the entire economy since the electronics industry is the toolmaker for other industries, providing the equipment needed to strengthen U.S. productivity, and the global competitiveness of all sectors of the U.S. economy. A healthy electronics industry is key to U.S. leadership in the evolving information age.

Declining International Competitiveness

The future of this industry in the U.S. is now in jeopardy due to a decline in the international competitiveness of our technology companies. As noted in the recently released Report of the President's Commission on Industrial Competitiveness, chaired by Hewlett-Packard Company's Chairman, John Young, U.S. companies have lost world market share in seven out of ten high technology sectors in the last 20 years. 2/

As a result of this loss of market share the surplus which these companies have traditionally contributed to the nation's trade balance (+$7.4 billion in 1980) became a serious trade deficit in 1984 (-$6.2 billion).

2/ Global Competition, The New Reality; Report of the President's Commission On Industrial Competitiveness (Young Commission); January, 1985, pg. 16.

e er yar ad a r laete y y ere.. yr arpl ecroe . y. lr lycp .yrle by. arylcpp n laetcrye. bylb pa.e beyr laete y y ere.. a er.ec. cp.a pa.e beyr ceypy a laete e c cyr. darey r tral 1 . yr.yle be Ps s Unfortunately, that is exactly what is happening today. As our American exporters have lost market share abroad, imported electronics products have increased their share of the U.S. market by 42% between 1980 and 1984. Meanwhile, the percentage of U.S. electronics sales derived from exports has fallen 19%.

This trend is costing the U.S. vital jobs today, and reliable access to new technologies critical to national defense in the future.

The Role of Tax Policy in Retaining U.S. Global Competitiveness

While the U.S. electronics industry itself must accept the primary responsibility for maintaining its global competitiveness, three keys to meeting the challenge which the federal government can affect are tax policy, budget policy, and trade policy. We address only tax policy here.

Despite their importance to the U.S. economy, American technology companies pay higher effective tax rates than firms in most other sectors. Studies by the Congressional Joint Committee on Taxation, the publication Tax Notes, and the Urban Institute conclude that high technology electronics companies pay from 25 to 60 percent higher effective tax rates than the average for U.S. industry. While our major trading partners support their industries with tax rebates on exports and strong incentives for research and investment, the U.S. tax system subsidizes consumer spending at the expense of job-creating capital formation.

Problems with the House Reform Bill

The House-passed tax reform bill continues this tradition. It reduces the R&D tax credit from 25 percent to 20 percent and extends it for only three years, thereby limiting both the value of the credit and its long-term incentive effect. The House bill increases the maximum tax rate on capital gains from 20 percent to 22.8 percent, thereby reducing incentives for risk capital investment. It also significantly reduces the amount of foreign source income eligible for credit against foreign taxes, thereby discouraging exports and encouraging the shift of U.S. jobs offshore. The cost of investment in capital equipment would also be increased by eliminating the investment tax credit and by stretching out depreciation schedules.

Mr. Chairman, AEA believes it is important that the final tax reform bill contain:

o A permanent, 25 percent incremental tax credit for R&D;

- A 20 percent maximum rate on individual capital gains;
- Incentives for exports, such as the current title passage sourcing of income rules of Section 863(b); and
- Improved incentives for capital investments, such as a tax credit for capital equipment investments and depreciation schedules which recognize the actual lives of equipment.

I will now turn to the specifics of AEA's concerns with the treatment of various provisions of H.R. 3838 that affect the international operations of U.S. companies and that affect R&D.

Treatment of Foreign Affiliate Royalties

The AEA strongly opposes the provisions of H.R. 3838 (in Bill Section 641) which require that royalties and other similar payments for technology transferred to foreign affiliates be measured not by traditional arms-length standards but by the level of net profits of the affiliate, taking into account variations from year to year. The provision would undo twenty years of progress in harmonizing the taxing regimes of the major developed countries of the world, lead to substantial international double taxation, cause continuous disputes between the IRS and U.S. multinational taxpayers, and, in the end, act to discourage U.S. companies from maximizing the share of their worldwide R&D performed in the United States.

Present Law: The Section 482 Arms-Length Standard for International Transactions

The U.S. tax code has long required under Section 482 that dealings between related parties generally, including between U.S. companies and their foreign affiliates, be conducted on an "arms-length" basis, as if those dealings were between unrelated parties. Most major developed countries have this same principle incorporated into their tax codes. Thus, under U.S. law where a U.S. company licenses technology to a foreign affiliate, that affiliate must agree to make royalty payments to the parent in a manner consistent with what an unrelated party would pay for a transfer of the same technology under the same terms and conditions. Similarly, virtually all major foreign countries allow a deduction for royalties paid by a local affiliate to its U.S. parent if the payment meets this arms-length standard. If the payments agreed to and made by related parties under licensing arrangements are inconsistent with unrelated party transactions, the IRS has the authority under Section 482 to increase the royalty by reallocating income to the parent. The taxpayer can then petition the foreign government to permit an increase in its local royalty deduction accordingly. If the foreign government disagrees with the IRS and is a party to a tax treaty with the United

States, the taxpayer can invoke the treaty "competent authority" mechanism, under which the two governments attempt to negotiate a mutual agreement resolving the issue. Through these procedures the taxing regimes of differing countries can be harmonized and international double taxation can be avoided.

House Bill Provision

The House bill provision would expressly abandon this present law framework in the United States and replace it with a requirement that royalties and other similar payments to U.S. companies for the use of intangibles "be commensurate with the income attributable to the intangible." The Committee Report expressly states the intent that "unrelated party transactions do not provide a safe-harbor minimum payment for related party intangibles" (Committee Report, at page 425). Rather the provision appears to require that payments be based on the actual level of net profits realized by the foreign affiliate regardless of the expectations for such profits at the time the license agreement was entered into. Further, as profitability levels vary from year to year after the agreement is made, the IRS can adjust the level of royalty payments notwithstanding the terms of the agreement.

The House Provision Undermines the Meshing of International Tax Regimes

The United States has long been a leading advocate of the use of arms-length standards to resolve international taxing disputes. Through the U.S. model tax treaty, the O.E.C.D. model tax treaty and specific U.S. bilateral treaty negotiations, the United States has been instrumental in persuading other nations to accept the arms-length standard. To abandon that standard now would seriously undermine these long- standing efforts.

It is clearly unrealistic for the United States to expect other countries to adopt the proposed new rules for their local tax purposes. Since royalty payments are tax deductible under the laws of our major trading partners, adopting the proposed rules would effectively be ceding substantial revenues to the United States. Just as the United States would not even seriously consider changing its tax laws if, for example, Germany or Japan adopted new rules for the treatment of royalties, we cannot expect foreign governments to respond to any such change by the United States.

The conclusion that foreign governments will not conform their systems to the proposed U.S. change is made even more clear by the fact that the House bill change is specifically limited to transfers of technology outbound from the United States and does not apply to transfers into the

United States. Essentially the House bill takes the position that a different and generally higher royalty may be required for licenses of technology by U.S. taxpayers to foreign manufacturing affiliates (where the royalties are taxed in the United States) than is required for licenses by foreign taxpayers to U.S. manufacturing affiliates (where the royalties are deducted in the United States). If the United States cannot accept the proposed provision to its own revenue detriment, it is surely unrealistic to expect any foreign government to do so.

Provision Will Create International Double Taxation

Because foreign governments will not adopt the proposed U.S. rule for their local tax purposes, U.S. companies will face the prospect of double taxation on at least some of their profits from foreign manufacturing. The United States will in effect force U.S.-owned foreign affiliates to make royalty payments which for foreign tax purposes are treated as nondeductible dividends. Moreover, the increased royalty payments to the United States, unlike dividend payments, will not bring along any foreign taxes in fact paid to offset U.S. tax on that income.

The threat of this double taxation can have a serious impact on multinational companies like Hewlett-Packard. As was mentioned previously, Hewlett-Packard conducts over 90 percent of its worldwide R&D in the United States. The company since its beginning has adopted the practice of licensing its technology to each of its foreign manufacturing affiliates under a single licensing agreement covering all products. In fiscal 1985 Hewlett-Packard collected more than $75 million in royalties from its affiliates under these agreements. The largest portion of this royalty income came from high tax jurisdictions, such as Germany, France and Japan. As a matter of corporate philosophy Hewlett-Packard requires each of its U.S. and foreign affiliates' activities to be self-funding. Thus, our intercompany licensing agreements must include a fair royalty charge. Otherwise, the licensing affiliate will not have sufficient resources to conduct R&D or the manufacturing affiliate will not have sufficient resources to pay for inventories and manufacturing facilities. This creative tension motivates our approach to setting intercompany royalties in a manner consistent with arms-length transactions.

The House bill gives IRS agents the authority to upset these long-standing arrangements, at least where a particular product in a particular year is more profitable than the average product. Because the resulting U.S. tax increase will not be offset by lower foreign taxes in high tax jurisdictions, the consequences for Hewlett-Packard can be serious.

The Provision Will Create Continuous IRS-Taxpayer Disputes and Lead to "Cost-Plus" Allocations of Manufacturing Income

While the House proposal specifically abandons the use of arms-length standards for determining related party royalties, it gives little guidance of what alternative principles or rules taxpayers should apply to determine proper royalty payments under the new provision. The statutory and Committee Report statement that any royalty should be "commensurate with the income attributable to the intangible" begs the question of how to determine the amount of income "attributable" to that intangible. If arms-length standards for such a determination are to be abandoned, perhaps some mechanical apportionment of income is intended to be applied. But no indication is given on how any such appointment is intended to be undertaken. Taxpayers and the IRS are left to dispute the issue without any guiding principles.

The Committee Report does state that foreign affiliate licensees using U.S.-developed technologies will not mandatorily be treated as mere "contract manufacturers" or "cost-plus" contractors (Committee Report, at page 426). Yet it would seem likely that in practice this result would occur. The abandonment of arms-length standards and the lack of guidance on any intended method of income apportionment leaves a cost-plus manufacturing type of analysis (with residual profits attributable to R&D and therefore included in the increased royalty) as the one obvious remaining method available for allocating income. Since this method is also generally the most favorable to the IRS, IRS agents can be expected to adopt it on audit. While taxpayers will argue strenuously against its application, they will likely have a difficult time persuading any court that the agents' determinations are arbitrary or unreasonable, as is required to avoid an IRS adjustment under Section 482. Thus, while the House may not have intended to "mandate" the use of a cost-plus manufacturing income method of pricing, and while taxpayers are likely to argue vigorously, that method would almost inevitably be applied to audited taxpayers.

Changes to Present Law Are Unnecessary

Most U.S. multinational companies have international licensing similar to Hewlett-Packard's arrangements: long-standing license agreements covering all present and future products at a single royalty percentage rate applied to sales revenue. These agreements have been reviewed and approved by U.S. and foreign governments over the years. They accomplish a reasonable division of profits between taxing jurisdictions and lead to relatively few disputes. Surely such facts cannot be seen as giving rise to the kind of abuses which would require abandoning traditional arms-length norms in new U.S. legislation.

Indeed, the Committee Report does not indicate any particular concern with these types of most common licensing arrangements. Instead the focus seems to be the less common case of a U.S. company that enters into a separate license agreement for one specific existing or new product in circumstances where the product could end up being substantially more profitable than average products of the taxpayer or the taxpayer's industry more generally. But even in this type of case the IRS has ample authority to require that the royalty payment be "commensurate" to the income from the intangible under present law. The recently decided Ciba-Geigy case 3/ makes clear (ironically, over IRS objections because the royalty was paid by a U.S. taxpayer to a foreign parent) that royalty payments on specific product licenses are to reflect the actual prospects for profitability of the specific licensed product and not general industry or other more standardized payment rates. Thus, any abuses which Congress may perceive arise not from defects in present law (or really even in current IRS regulations) but from an IRS failure to interpret and enforce the law in the manner permitted under cases like Ciba-Geigy.

3/ Ciba-Geigy v. Commission, 85 T.C. 172 (1985).

Conclusion

For all the reasons stated above -- the abandonment of well-established international taxing norms, the potential for international double taxation, the likelihood for continuous disputes with the IRS and the failure to identify any abuses which cannot be prevented under present law -- we strongly urge that the Senate reject any changes to Section 482 or Section 367(d) with respect to foreign affiliate royalties.

Impact of Other Provisions

While the proposed changes to section 367(d) and section 482 are the focus of my testimony today, I thought it would be useful to review for the Committee the position of the AEA with regard to several other provisions of the House bill that would have a significant effect on the international competitiveness of electronics companies.

Allocations of R&D Expenses Under Regulations Section 1.861-8

Treasury Regulations Section 1.861-8 requiring apportionment of U.S. R&D expenses against foreign income are excessive, arbitrary, inequitable and deter U.S. R&D spending. These rules have been temporarily suspended and studied since 1981, largely because of a concern that they will encourage United States companies to move R&D outside of the U.S. The moratorium on apportionment of R&D expenses has lapsed, but it should be made permanent during the current tax reform effort.

H.R. 3838 moves somewhat in this direction, by allocating 50% of U.S. R&D to U.S. source income and the remainder between U.S. and foreign source by sales or gross income, but only for two years. Permanent extension of the moratorium, which more appropriately allocates 100% of U.S. R&D expenses to U.S. source income, would help ensure that R&D will be conducted in the United States, which will also help to keep manufacturing and service jobs in the United States.

The basic overall foreign tax credit ("FTC") limitation is determined by the following formula:

$$\text{FTC Limitation} = \text{U.S. Tax Before Credits} \times \frac{\text{Foreign Source Taxable Income}}{\text{Total Taxable Income}}$$

This formula is designed to ensure that foreign taxes will not be used to offset U.S. tax on U.S. source income. A dollar of R&D expenses allocated to foreign source taxable income will reduce the numerator of the fraction above. As a consequence, the limitation will be reduced by 46 cents, which reflects the U.S. statutory tax rate of 46% applied to foreign source income. However, R&D expenses incurred in the United States and allocated to foreign source income would not be deductible in foreign countries. Accordingly, when the foreign taxes paid by a U.S. taxpayer exceed the FTC limitation, the resulting U.S. tax liability would be increased.

For taxpayers in an excess foreign tax credit position, the only way to ensure full tax deductibility of R&D expense on a worldwide basis would be to transfer R&D activities outside the United States to Canada, the U.K., Germany, Japan, or other countries. The United States should not encourage such transfers. Instead, the penalty imposed on the conduct of R&D in the United States by the current Section 1.861-8 regulations should be ended by making the moratorium permanent. Doing so would not itself be an incentive for doing R&D in the United States, but it would remove a substantial disincentive.

Furthermore, because the disincentive effect of Section 1.861-8 operates only on companies in an excess foreign tax credit position, such companies are at a competitive disadvantage with foreign companies (as well as other U.S. companies not in an excess credit position). The companies that are affected by the Section 1.861-8 R&D rules tend to be multinational companies that are in an excess credit position because they pay relatively high foreign taxes (due to significant profits in high-tax jurisdictions) and conduct a significant amount of R&D in the United States. Such companies frequently are major exporters from the United States.

Under both H.R. 3838 and Treasury II, however, most U.S. taxpayers would be in an excess credit position. This would occur because of lower tax rates, expanded separate-basket FTC limitations, changing the source of export income from foreign to U.S., and other proposed changes. As a consequence, many more taxpayers will have excess foreign tax credits. For such companies the after-tax cost of conducting R&D in the United States would increase dramatically.

The benefit of the R&D credit as a stimulus to R&D in the United States would be substantially offset under the Section 1.861-8 regulations because incremental research conducted in the United States will not be tax deductible. As long as U.S. tax policy is designed to encourage research in the United States, the disincentive of the Secton 1.861-8 regulations through the denial of full deductibility of R&D expenses makes little policy sense.

Unfortunately, under current Section 1.861-8 rules, the only way to ensure full tax deductibility of R&D expenses is to perform the R&D in foreign countries. Imposing a permanent moratorium on the Section 1.861-8 regulations to ensure that R&D expenses are entitled to a tax deduction should provide a better environment to assure senior corporate management that conducting R&D in the United States makes good economic sense.

H.R. 3838 Increases Taxes on Exports - Source Rule Eliminated, FSC Curtailed

H.R. 3838 would eliminate or significantly reduce two important incentives for U.S. exports. First, the title passage sourcing rule that treats part of the income from U.S. exports as foreign source income would be eliminated. Second, the percentage of export income exempt from tax under the Foreign Sales Corporation (FSC) provisions would be reduced from 15% to 13%.

The clear impact of both provisions would be a substantial tax increase on United States exports. At a time when Congress is searching for effective means to reduce our record balance-of-trade deficit, adopting such provisions would be counter-productive.

Congress recognized the need to provide effective tax incentives for U.S. exports when it adopted the FSC provisions in 1984. Lowering the benefits available under those provisions would considerably reduce their stimulative effect.

The title passage sourcing rule was affirmed and modified by Congress at the same time that it adopted the FSC provisions. This sourcing rule provides an incentive for U.S. exporters by treating a portion of their export income as foreign-source income, which improves their ability to utilize foreign tax credits. This incentive has not been challenged under GATT, which was a major difficulty under the DISC rules.

Furthermore, in some cases this sourcing rule is essential to prevent international double taxation of export income.

H.R. 3838 Would Discourage R&D in the United States

There are a number of ways in which R&D would be discouraged by H.R. 3838 compared to current law.

1. The R&D credit is reduced from 25% to 20%. Furthermore, it is extended for only three years, instead of being made permanent.

2. The moratorium on R&D allocations under Section 1.861-8 was not made permanent. H.R. 3838 would allocate only 50% of U.S. R&D expenses to foreign source income for only two years.

3. The proposed changes to Sections 367(d) and 482 would lead to uncertain results if taxpayers conducting R&D in the U.S. license technology to foreign affiliates. A clear way to overcome this uncertainty and that of allocations under Section 1.861-8 is to conduct R&D outside the United States.

4. The depreciation period for most R&D equipment would be extended from 3 years under the current ACRS system to 5 years or longer under H.R. 3838.

CONCLUSION

R&D is the basis of technological innovation and international competitiveness for U.S. electronics companies.

Successful R&D results in many jobs in the manufacturing and service sectors as well.

Several provisions of H.R. 3838 would create substantial disincentives for conducting R&D in the United States, such as the proposals concerning Section 1.861-8 of the income tax regulations and Sections 367 and 482 of the Code, while diminishing the effectiveness of the R&D credit. Other provisions of H.R. 3838 would increase taxes on exports.

At a time of record trade deficits and intense international competition, fueled by other countries' incentives for their companies, the U.S. can ill afford to create a less favorable environment for companies to conduct R&D in the United States, or to export manufactured goods from the United States.

STATEMENT OF RAYMOND WIACEK, PARTNER, JONES, DAY, REAVIS, AND POGUE, WASHINGTON, DC; ON BEHALF OF THE EMERGENCY COMMITTEE FOR AMERICAN TRADE

Mr. **Wiacek**. Thank you. My name is Ray Wiacek, and I am a partner in Washington with Jones, Day. I am appearing today on behalf of the Emergency Committee for American Trade issues or ECAT, an organization of over 60 large American companies specifically interested in international tax and trade issues. ECAT companies have annual worldwide sales in excess of $700 billion and they employ over 5 million people. I have submitted a written statement for the record so this morning I would like to make just a few general observations about the House international proposals, and then I would like to talk about a couple of provisions in particular. I would also be happy to take any questions.

My first general observation concerns the so-called abuses used to justify the House proposals. In my view, in virtually every case these abuses could be addressed by provisions much less sweeping and much less damaging to our position overseas. In other words, I believe the House frequently used an elephant gun to shoot a mouse. In our written submission, we have suggested just such alternatives with respect to virtually all of the House proposals. We hope they prove constructive. There is probably not time to review them this morning, but I would be happy to take any questions with respect to them.

The second general observation I would like to make is that the proposals are revenue driven. They specifically target the overseas operations of U.S. business for some $13 billion in additional taxation.

And the third general observation that I would like to make is perhaps the most important——

Senator **Chafee**. Now, what was that last figure?

Mr. **Wiacek**. $13 billion in additional taxation targeted directly at the overseas operations of U.S. businesses. That is in addition to all the other changes that you have heard about in your hearings this summer.

Senator **Chafee**. This bill does that?

Mr. **Wiacek**. This bill raises approximately $13 billion over 5 years specifically from the foreign sector.

The last general point I would like to make is that the proposals depart from longstanding international norms in the tax field. And what this means is that although there will be many calls to "level the playing field," in the international area the United States does not control the playing field. So, until the United States convinces its foreign trading partners to level the same field, unilateral adoption of the House proposals is akin to shooting yourself in the foot. At best, it tilts the field against us.

Senator **Chafee**. Now, you are mixing a metaphor, but we will excuse that. [Laughter.]

Mr. **Wiacek**. The first specific provision I would like to address is the elimination of deferral for banking, shipping, and insurance. Deferral, as you know, is a policy that says we do not tax income until it is received. ECAT has always opposed efforts to overturn this policy, in cooperation with many on this committee. We have also always known, however, that this is a policy that potentially is subject to abuse, so we have always had so-called subpart (f), which does tax on a current basis certain passive, related party transactions. But the House proposal targets real businesses—active businesses—involved in third-party transactions. ECAT is very much concerned for these businesses because it thinks that this proposal stands tax policy on its head in this area, We are also concerned that it is a terrible precedent and may serve as a beachhead for a general attack on deferral.

A related proposal is the so-called separate basket limitation with respect to foreign tax credits. The purpose of a foreign tax credit limitation is to make sure that U.S. taxes on domestic source income are not offset by foreign taxes. Current law does this perfectly, and the House proposal will do no better. Its purpose is instead to take the income of an integrated business and chop it up into a series of separate baskets, so as to create artificially a pot, or basket, that is taxed at less than 46 percent, so the United States can tax up the difference.

In the foreign tax credit area, ECAT is also very concerned with a provision which would substantially reduce foreign tax credits for withholding taxes on interest earned by U.S. lenders on cross-border loans. This provision will impede the growth of U.S. exports by reducing the amount of international credit available and by undermining the ability of U.S. lenders to compete with foreign banks. Regional and money center banks are so concerned with this proposal that they have asked ECAT to make a supplementary submission with respect to it.

The last specific provision I would like to talk about is the one known as sourcing. In order to compute your income taxes, you have to distinguish domestic and foreign income; and the United States has long used a 50–50 rule of thumb which treats income with respect to goods manufactured in the United States but sold overseas as 50-percent foreign and 50-percent domestic. This recognizes the international aspects of the transaction. The House proposal would treat such a transaction essentially as all domestic, ignoring the international aspects of the transaction. And this proposal is death to U.S. exporters. It falls very heavily on the large U.S. exporters.

I have run out of time, so let me just say in conclusion that, although I have talked very quickly——

Senator **Chafee**. Try to make your conclusion quick because we have a vote on, and I think we will try and take Mr. Loree before we recess.

Mr. **Wiacek**. The conclusion is 10 seconds.

Senator **Chafee**. You have got it; go ahead.

Mr. **Wiacek**. Although I have talked quickly, we haven't scratched the surface of any number of other foreign provisions. There is the allocation of interest to foreign source income; it is the biggest revenue item, and it affects every business that borrows—that is, everyone. There is the 367/482 royalty provision discussed by my colleague. Another provision of concern is the extension of the section 861 R&D moratorium, which many members of this committee have long been interested in, and there are others that merit your attention. Thank you.

Senator CHAFEE. Ten seconds. Mr Loree.

[The prepared written statement of Mr. Wiacek follows:]

TESTIMONY OF RAYMOND J. WIACEK
ON BEHALF OF THE
EMERGENCY COMMITTEE FOR AMERICAN TRADE

My name is Raymond J. Wiacek, and I am a partner in Washington with the international law firm of Jones, Day, Reavis & Pogue. I am appearing on behalf of the Emergency Committee for American Trade, or "ECAT," an organization that represents over 60 large United States corporations interested in international tax and trade issues. My comments will address the international provisions contained in the Ways and Means tax bill, particularly those not proposed in Treasury I or II.

ECAT is keenly interested in these international provisions. ECAT's members have annual worldwide sales of over $700 billion, and employ over five million workers. They conduct business in virtually every market in the world, against formidable competition from Japan, Germany, and other countries. They also account for a substantial portion of total U.S. exports and are among the largest U.S. investors overseas.

Before discussing specific provisions, several features common to all of the Ways and Means-initiated international proposals should be noted. First, although of obvious and crucial importance, no hearings were held on the proposals.

They arose very late in the game, often in one page "Task Force" reports, and were not subject to the debate and analysis which should precede change of the scope represented by the proposals.

Second, virtually every one of the proposals departs from longstanding practices used throughout the world in taxing international transactions and avoiding double taxation. If enacted into law, the proposals would subject U.S. companies competing abroad to complex new tax rules not imposed by Japan, Germany, Britain, France, Korea, or other countries on their companies. This makes clear a very obvious feature of tax revision in the international arena -- the U.S. does not control the field. Thus, while it may be acceptable to talk about "base broadening" or "level playing fields" when discussing domestic tax reform, these concepts should not be applied to international taxation until the U.S. persuades our foreign trading partners to level the same field.

Third, the proposals are supposedly necessary because of the "tax-motivated" or "abusive" nature of U.S. investment abroad. But alternatives to the Ways and Means proposals which specifically target the "abuses" cited by Ways and Means are easy to craft, and do not require the sweeping changes adopted by Ways and Means. Moreover, U.S. companies go abroad for business, not tax reasons. They go abroad to get within custom and tariff barriers, to meet the regulatory requirements of foreign governments, to exploit natural resources, to provide parts and service to foreign customers, and to compete generally in the international marketplace. Recent Department of Commerce data shows that over 95% of all U.S. investment overseas is made in countries with tax rates comparable to or higher than those in the U.S. This statistic alone proves that the case cannot be made regarding "tax-motivated" foreign investment.

Fourth, the proposals are revenue-driven. They will burden the international operations of U.S. companies with over $13 billion in additional taxes.

Finally, the proposals will harm the competitiveness of U.S. companies doing business overseas. It will subject them to new rules of taxation not used by any of our competitors, in order to extract billions of dollars of new taxes not faced by any of our competitors. This raises the obvious question of who is most likely to succeed in competing for international business -- the U.S. firm carrying a huge new tax burden or its foreign competitors whose governments continue to follow long-accepted norms of international taxation.

A discussion of the major international proposals adopted by Ways and Means, together with suggested alternatives, follows.

Deferral

The U.S. does not tax the income of foreign corporations until returned to the U.S. This is commonly referred to as "deferral." (The word deferral is misleading to the extent it suggests that a tax benefit has been granted, because what really is involved is the entirely appropriate policy of the U.S. not to tax income that has not been received.) Subpart F embodies certain exceptions to deferral. The underlying theory of subpart F is that income earned in passive transactions between related parties is potentially abusive. Active, unrelated party transactions are subject to deferral -- that is, real businesses conducting real international operations are not taxed currently on funds they have not received.

The Ways and Means bill contains provisions that would blur the distinction between active, unrelated party and passive, related party transactions. Targeting certain industries, the Ways and Means bill eliminates deferral for all banking, insurance, and shipping operations. This change is not limited, say, to one-man banks formed in the Caribbean. It by its terms is aimed at bona fide, active, unrelated party transactions in very important businesses.

ECAT is concerned that treating foreign income as taxable in the U.S. before it is received will present significant problems in countries which limit or block the repatriation of income to the U.S.

ECAT is also concerned that foreign banks, insurers, and shippers, which are not taxed currently by their governments on income they have not received, will achieve a competitive advantage.

But ECAT is most concerned that the Ways and Means provision will serve as the beachhead for a general attack on deferral. ECAT is opposed to the abandonment of the longstanding tax policy distinguishing passive, related party transactions from active, bona fide operations conducted with the general public. If Congress permits the elimination of deferral today for bona fide bank, insurance, and shipping companies, will electronics, chemicals, or consumer products be next?

The elimination of deferral has long been on the agenda -- hidden or otherwise -- of some who style themselves tax reformers. Congress has repeatedly rejected their blandishments. ECAT historically has been very much involved in these developments, and resisting the piecemeal approach to eliminating deferral should be a top priority in the current tax reform debate.

Alternative. Once it is conceded that active, unrelated party transactions are not abusive, operations seeking to avoid subpart F by calling themselves "banks," "insurers," or "shippers" could be included within subpart F. For example, "incorporated savings accounts" or one-man island banks could be covered by providing that any "bank" owned by 5 or fewer individuals (or by a company or companies owned by 5 or fewer individuals) would not be treated as bona fide. Additionally, a bank would not be treated as bona fide unless it met some commonsense tests -- for example, unless it had tellers, incurred expenses, made loans to third parties, issued letter of credits to third parties, and so on. Finally, exclusion from subpart F could be conditioned on the availability of books and records in a manner reasonably comparable to domestically situated books and records (consistent with treaty agreements, if any, and local law).

This alternative would address any abuse about which Ways and Means may have been concerned, but would respect the real banking, insurance, or shipping operations of large, publicly-traded companies with nothing to hide.

Sections 367 and 482

The Ways and Means bill contains a "sleeper" which will drastically change the pricing, licensing, and use of high technology throughout the world. This provision would require payments for the use of technology abroad to be reset on a periodic basis, even if the payments were set in the first instance at arm's length, taking into consideration all relevant facts and circumstances.

This proposal seems inocuous enough. But what is intended is for the IRS to have the power to exact -- legally -- ever higher payments from U.S. affiliates operating abroad. Assume, for example, a European affiliate of a U.S. company which actively manufactures and sells a product in Europe against German, French, and British competition, using technology for which it pays its U.S. parent a 10% royalty. Assume further that this is truly an arm's length royalty, because it is the same rate the U.S. company charges an unrelated Japanese concern to use the technology in Japan (a market to which the U.S. company is denied access). When the European company's sales increase, the royalty to the U.S. parent increases, because the royalty is set in percentage terms. Under the proposed new rule, however, the IRS can adjudge the increase to be "inadequate" and exact a higher return.

To invoke the new rule, the IRS will not be required to show that the 10% royalty was set too low or was otherwise unfair to the U.S. parent in the first instance. The IRS need only feel that "not enough" is being paid currently to the U.S. Thereafter it may demand, say, a 50% royalty. The royalty paid by the Japanese concern, in contrast, will remain at 10%, because the new rule applies only to related parties, and because in the real world a deal is a deal.

This proposed new rule is divorced from commercial reality. Unrelated parties do their best to negotiate an agreement using all the facts and circumstances known at the time, and thereafter they live with the agreement negotiated. Royalty rates, for example, are set for the life of the product involved, and are not periodically reset or increased. (If anything, unrelated parties provide for caps or decreases in royalty percentages as sales grow.)

The proposal also contradicts longstanding U.S. and international tax principles. In divorcing itself from the real world practices of unrelated parties, the proposal abandons the arm's length standard relied on throughout the world as the touchstone of international pricing. The OECD has addressed this specifically with respect to technology:

> "The general principle to be taken as the basis for the evaluation for tax purposes of transfer prices between associated enterprises under contracts for licensing patents or know-how is that prices should be those which would be paid between independent enterprises acting at arm's length."

It is also unlikely our major trading partners will accept the new rule, which will lead to double taxation of U.S. companies competing abroad. One cannot believe, for example, that Germany will allow a higher royalty to be exacted from a German user of technology -- by either the U.S. Government or U.S. transferor -- based on the success of a product in Germany.

Although representing a major change, no hearings were held concerning the proposal. Nor was it mentioned in Treasury I, Treasury II, or the Staff Options. In fact, it was hidden among section 936 changes, although its impact extends far beyond Puerto Rico. ECAT has been told by many high tech companies that this is their number one international issue.

ECAT believes the new rule will harm U.S. international competitiveness. It is complicated and arbitrary, and will increase planning uncertainties and administrative expenses. It will lead to double taxation, burdening U.S. companies as compared to their foreign competitors. Most important, it will interfere in business decisions as to how, when, and where U.S. technology should be employed, robbing the U.S. of its primary advantage in the international marketplace.

Alternative. ECAT understands that there was concern that technology which could be reasonably predicted to be successful was being licensed at rates considered too modest. The staff referred to this as the "hot product" or "crown jewel" problem. Since royalties are usually set in percentage terms, resulting in larger payments as products prove successful, ECAT does not agree there is a "hot product" or "crown jewel" problem. Accordingly, and in light of the fundamental nature of the Ways and Means proposal and the complete absence of hearings, ECAT does not believe the Ways and Means proposal should be adopted. Stated otherwise, under no circumstances should an agreement concluded in line with arm's length principles be deemed renegotiable by U.S. tax law.

Section 861 and R&D

The current section 861 regulations treat a portion of U.S.-incurred R&D as if it were foreign. The Treasury believes this is necessary because the R&D is utilized not only in the U.S., but abroad as well. (Note, however, that royalties are usually paid to compensate for this foreign utilization; in fact, the changes to section 367 made last year by DEFRA require fair market royalties to be paid in such cases.)

Many believe it is bad policy to treat any U.S. R&D as if it were conducted abroad, because it encourages such R&D in fact to be conducted abroad. Even those who believe that tax theory requires at least some such treatment agree that the treatment prescribed by the current regulations leads to results which are mechanical, harsh, and incorrect. That is why a series of moratoriums have been passed by Congress.

There was support on the Ways and Means Committee, and there is support in the Finance Committee, to continue the moratorium, particularly since the Treasury has not proposed a permanent solution reasonably revising the harsh treatment called for under the current regulations. A temporary extension of the moratorium was included in the Senate's reconciliation and "extender" packages. Many Members, in fact, would make the moratorium permanent.

Alternative. The Ways and Means bill contains a two-year, "half" moratorium. This was clearly an expedient, temporary, and minimally acceptable "solution." The business community would prefer an extension of the moratorium. But in light of the revenue pressures underlying the Ways and Means effort, some companies told the Treasury and Ways and Means staff that a compromise permitting a permanent 75% "set aside," instead of the temporary 50% set aside found in the Ways and Means bill, would be accepted as a permanent solution if it were endorsed by the Treasury and Ways and Means. Note, however, that the other features of the Ways and Means approach should not be revised to offset this higher set aside. In particular, no "technical" suggestion from the Treasury or staff to revise the gross income formula approved by Ways and Means should be considered.

Sourcing

Income from goods manufactured in the U.S. for export are generally treated under current law as 50% U.S. source and 50% foreign source. The Ways and Means bill will generally treat such income as all domestic. (The Ways and Means exception to all domestic treatment applies only where the export is subject to foreign taxation. While this exception may benefit foreign countries, it will help neither the exporter nor the U.S.)

Treatment of export income as all domestic will adversely affect the exporter's foreign tax credit calculations, and increase its worldwide tax burden. Treatment of the income as

50% domestic and 50% foreign is an approximation, admittedly, but it is a Solomon-like one which produces a readily administrable rule which recognizes that the product is being marketed and sold in a foreign country, to a foreign purchaser, for foreign funds. The all domestic rule fails to recognize that the transaction is in any way international. It also fails to recognize that because many other countries have sourcing rules like these now employed by the U.S., changing the current U.S. rules will produce double taxation.

It is important to note, in addition, that increasing the worldwide tax burden of U.S. exporters at a time when severe harm has already been done by the strong dollar, tariff barriers, closed markets, hidden subsidies to foreign competitors, and other factors, constitutes bad trade policy. Many large exporters believe this is the most important change made by the Ways and Means bill. There are other changes to the sourcing rules affecting transportation, 80-20 companies, intangibles, and other property, which may be discussed by certain companies or industries, but as a trade matter, the changes affecting the export of goods from the U.S. are by far the most significant.

Alternative. ECAT believes the fair and administrable rules embodied in current law are much preferable to the wholly arbitrary, all domestic proposal adopted by Ways and Means. But if changes in current law are deemed necessary, new rules which require a minimum level of direct or indirect overseas operations -- short of "permanent establishment" status -- would curtail "abuses" without harming U.S. exports, and would avoid the recharacterization of truly international transactions as all domestic.

Foreign Tax Credit Limitations: Overall, Per Country, and Separate Baskets

The purpose of a foreign tax credit limitation is to insure that U.S. tax on U.S. domestic income is not reduced by credits for taxes paid abroad. The limitation contained in current law, known as the "overall" limitation, does this absolutely and completely. It allows credits to be claimed only up to the amount of U.S. tax that would otherwise be imposed on the foreign income in question. It is easiest to calculate the overall limitation by multiplying foreign income by 46% (the U.S. tax rate). For example, if a company earns $200 abroad, on which it pays $100 in foreign taxes, it will be allowed only $92 as a credit (46% of $200). The other $8 paid in foreign taxes cannot be used to offset taxation of domestic income.

The Administration proposed a "per country" limitation to replace the overall limitation. The per country limitation would not have accomplished the objective of a foreign tax credit limitation any better than the overall limitation -- that is, it would not have better protected U.S. taxation of domestic income. Its purpose was different. It was meant to increase U.S. taxation of foreign income, even when that foreign income was already subject to a very high rate of foreign tax. In terms of the example used above, the per country approach would first break down the $200 earned abroad into $100 earned in, say, Germany and $100 earned in Italy, and would similarly segregate the foreign taxes paid into, say, a $60 German pot and a $40 Italian pot. The credit claimable would be limited separately for the two countries -- that is, German income would be multiplied by 46% and Italian income would be multiplied by 46%. There would be no additional U.S. tax on the German income, because German taxes paid exceeded $46. But the per country approach would hold that "insufficient" taxes had been paid as to Italian income, such that the U.S. was entitled to an extra $6 in tax.

The bottom line is that the company involved would see the tax rate on its foreign operations increased to 53%. The tax imposed on its domestic income would not be affected, because the per country proposal had nothing to do with protecting taxation of domestic income.

The per country proposal was unanimously opposed by the international business community, and was ECAT's primary focus on the House side. Even companies publicly identified as supporting the Administration's tax proposals objected to the per country proposal. It was very obvious to all that it increased the taxes imposed on the international operations of U.S. business, to the detriment of U.S. competitiveness.

The staff replaced the per country proposal with a series of separate baskets. Although more subtle than the per country approach, the basket approach has the same purpose. It artifically divides the foreign income of a worldwide business, but does so by type-of-income or line-of-business instead of by country. The objective is to increase U.S. taxes on foreign income, not to protect U.S. taxation of domestic income. In terms of the example above, the separate basket approach would take a business with $200 of foreign income taxed at 50% and break down that business in order to isolate a type-of-income -- say, a royalty -- or a line-of-business -- say, a financing operation -- that could be treated as if it were taxed at less than 46%. Then the U.S. would quickly impose its tax on the "under-taxed" type-of-income or line-of-business.

The staff justifies this approach by stating that calculating foreign tax credits based on the overall, or "average," foreign taxes paid is an abuse. This sentiment was unanimously opposed when offered in justification for the per country proposal. Academicians do not agree that averaging is an abuse. But perhaps most important, all of our major trading partners permit averaging (or better). Japan, for example, uses the system embodied in current U.S. law. This means that U.S. companies will face an increased tax burden in competing for international business that no foreign competitor will face.

Finally, the basket approach itself contradicts any assertion that averaging is abusive. In so doing, moreover, it intrudes tax considerations into business decisions and is applied unequally. This is best seen in the Committee Report's statement "that a bona fide bank, insurance company, or shipping company, while it should not be able to average its banking, insurance or shipping income with any other, unrelated types of income, generally should be able to obtain the benefits of foreign tax rate averaging with respect to its active business income to the same extent that, for example, a manufacturing or service enterprise can." In other words, independent banks, insurers, and manufacturers can use the overall approach -- so averaging cannot be so bad -- but a manufacturer with a financing arm or a diversified service company with an insurance operation cannot. This means that a manufacturer deciding as a business matter whether it is prudent to use of some of the funds it has earned abroad to expand into financing will have to take into account the tax costs of the separate basket approach. In other words, if it implements its business decision, it will not be able to calculate its foreign tax credits in the manner, in effect, used by independent U.S. financing companies and used by every one of its major foreign competitors. Why?

Alternative. If some "reform" is needed in this area, we would suggest, in conjunction with the elimination of the separate baskets and the preservation of current law, the addition of portfolio dividends to the separate limitation on interest now part of current law. This reform was proposed as part of the Administration's package.

Other Major Policy Issues

Puerto Rico. The Ways and Means bill reduces the benefits available to companies operating in Puerto Rico and other U.S. possessions by at least 10%. This follows the major cut backs exacted by TEFRA. Many organizations and companies, as well as the Commonwealth of Puerto Rico, have been active on this issue. In addition to the reduction in benefits, companies are most concerned about misunderstandings among the Administration, Puerto Rico, and the business community regarding Puerto Rico's so-called "twin plant initiative."

In Lieu Of Withholding Taxes. Banks are opposed to the Ways and Means bill's attack on foreign tax credits attributable to gross withholding taxes imposed, in lieu of income taxes, on the interest earned abroad by banks on their foreign loans. This will greatly increase the worldwide tax burden of U.S. banks operating internationally, and will inevitably increase their customers' cost for funds. It will also make the U.S. banks much less able to compete against large Swiss, Japanese, German, and other foreign banks. Since almost half of the loans in question are made to the Third

World, this provision also seriously affects U.S. economic and foreign policy. ECAT expects that this will be the top international priority of many money center and regional banks.

Foreign Sales Corporations. The Ways and Means bill would substantially curtail the benefits of a FSC in two ways. First, exempt foreign trade income of a FSC would, in effect, be treated as a preference for FSC shareholders under the new 25 percent alternative minimum tax. Second, under a separate provision, the bill would reduce FSC benefits by approximately 13 percent.

It is inexplicable that Congress would seek to cripple the export incentives provided by FSC only a year after its enactment. It does not make sense in terms of trade or tax policy to treat FSC exempt foreign trade income as a preference. As a practical matter, this will nullify FSC as an export incentive for many taxpayers. Moreover, the objective of a minimum tax -- that is, requiring all taxpayers to pay some tax -- is not applicable to a FSC, because the FSC provisions themselves are a carefully considered arrangement providing for a statutory minimum tax on export income.

The inclusion of FSC income as a preference for minimum tax purposes has the effect of raising the level of taxation on exports--at a time when the U.S. export situation is deteriorating--and increasing that rate of taxation as the size of a given firm's export operations increase. The FSC export incentives should not be eroded by including FSC benefits as a preference or by otherwise reducing FSC benefits.

Interest Allocation. The Ways and Means bill revokes current regulations on the treatment of U.S.-incurred interest expenses as they relate to foreign tax credit calculations, by requiring U.S.-incurred interest expenses to be allocated under section 861 against foreign income on a consolidated basis. In addition, the Ways and Means bill requires the allocation to be calculated based on assets, includes a portion of the undistributed earnings and profits of foreign subsidiaries in assets, and eliminates the gross income alternative now permitted throughout the 861 regulations. (The elimination of the gross income method itself is of major concern to most industries.)

This proposal will greatly reduce the credits claimable by any business which has in the past or plans in the future to undertake major U.S. borrowings. It will also place U.S. multinationals at a competitive disadvantage with foreign corporations operating in the U.S., with respect to the cost of borrowing in the U.S. to finance U.S. investments.

Although requiring consolidated U.S.-incurred interest to be allocated to foreign income, the Ways and Means bill does not take into account foreign-incurred interest related to this income. It provides no safe harbor or other mechanism for recognizing borrowing done on a worldwide basis. Moreover, the bill overturns current law too abruptly, applying, at least in part, to loans already outstanding.

The revenue estimate for these changes exceeds $3 billion, making it the single biggest international item in the House package. It does not discriminate among industries, adversely affecting energy, consumer products, manufacturing, chemicals, and other industries.

Technical Issues

The Ways and Means bill embodies a number of "technical" changes which, while they may not involve much revenue, are inappropriate as a matter of tax policy. For example, the Ways and Means bill would make the shareholder of a foreign investment company ("FIC") taxable on a current basis and at ordinary rates whether or not the shareholder -- or any group of shareholders -- had a controlling interest. Control, of course, is the key to the current taxation permitted in the case of controlled foreign corporations and foreign personal holding companies -- that is, in the case of subpart F generally.

Without control, one could question the constitutionality of the provision under Eisner v. Macomber and its progeny. But irrespective of constitutionality, the unfairness underlying the proposal is clear. The only answer to the question of what a non-controlling FIC shareholder should do to generate the cash necessary to pay the U.S. taxes due under the provision is "sell." And even this answer is not available if the FIC is "closed-end," with no ready market for its shares. In fact, the FIC which most shows the inappropriateness of the Ways and Means approach is a closed-end FIC, some of whose non-controlling shareholders are resident in, but not citizens of, the U.S. These shareholders have three choices: leave the U.S., attempt to sell their shares (if possible at all, at a discount), or borrow to meet their new U.S. tax liabilities. What is the purpose?

The FIC changes could be viewed as another selective attack on "deferral" and opposed by the investment and business communities generally. But we prefer to think that the approach taken in the Ways and Means bill can be corrected as a technical matter. For example, closed-end FICs, or closed-end FICs in existence as of the date of Ways and Means action, could be excepted from the new provision. Alternatively, if current taxability is required, gain should retain its character as gain and should not be taxed as ordinary income. This would be consistent with the treatment already accorded regulated investment companies.

Another technical issue cited by several of the tax directors of ECAT companies is the proposed abandonment of the

Bon Ami method of interrelating currency translation and foreign tax credit calculations. The new method proposed is unbelievably complex, and is likely to distort repatriation and investment decisions if followed.

Under the proposal an exchange gain would accompany dividends from strong currency countries and exchange losses would accompany dividends from weak currency countries. Gains would be taxed as ordinary income and losses deducted as ordinary losses. These gains and losses would be placed in yet another separate basket for foreign tax credit purposes. Because foreign taxes are unlikely to be applied to these foreign currency translation gains, they will in effect be taxed as U.S. source income. The losses also may be allocated among (and thereby reduce) income in the other baskets. The result will be a decrease in credits claimable. The bottom line is a reduction in credits claimable.

The Bon Ami approach has advantages and disadvantages but the proposed alternative is worse. As the U.S. dollar fluctuates over a period of time, Bon Ami tends to be revenue neutral. Its prime advantage is that it is understood and simple to apply. It does not distort investment decisions and can be applied as easily by both large and small corporations. It can be easily audited by the IRS.

Finally, the Ways and Means bill would modify the definition of a controlled foreign corporation for purposes of subpart F by lowering the "more than 50% voting" standard to a "50% or more vote or valuation" standard. This proposal is unfair where the U.S. company involved does not exercise control, which is frequently the case in 50%/50% joint ventures with foreign partners. In such a case, the proposal will trigger tax on subpart F income that the U.S. company will not receive because it lacks the control required to force a distribution. At a minimum, this proposal should be made effective for joint ventures formed after December 31, 1985.

Thank you for the opportunity to present these comments.

STATEMENT OF PHILIP J. LOREE, CHAIRMAN, FEDERATION OF AMERICAN CONTROLLED SHIPPING, NEW YORK, NY

Mr. LOREE. Thank you, Mr. Chairman. American controlled shipping is unique among the foreign investments that would be impacted by H.R. 3838 for two reasons. First of all, the ships we are talking about are 335 ships of 40 million deadweight-tons and are relied upon by U.S. defense planners for national defense and national security purposes. I don't think there are any other foreign investments that fall within that category. And second, our business is in the throes of a severe economic recession with too many ships that are chasing too few cargoes. Our fleets are shrinking. Companies are leaving the business; and those that are left are struggling to survive with even increased competition in a business that has always been notorious for being competitive. We are competing—and when I say "we," I am talking of tankers, bulk carriers, passenger cruise ships, you name it—we are competing in trades in which U.S.-flag vessels cannot compete. We represent roughly 10 percent of the tonnage in those trades. The rest of the tonnage—the 90 percent—is controlled by foreign shipping interests from such faraway places as Hong Kong, Greece, Norway, Great Britain, West Germany, Denmark, Japan, and so forth.

All of our competitors are able to reinvest their earnings and profits into new shipping investments or repay their loans; and we have had that privilege, too, under U.S. tax law from time immemorial. The House Ways and Means Committee in one of its final sessions, without any hearings on the matter, and with a proposal that was not supported, so I understand, by the administration, came out and adopted a provision that would repeal the reinvestment provisions of subpart F for American-controlled shipping.

And what this would do, quite simply, would be to put us in an untenable position against our foreign competition. They would be able to repay their loans, build new ships, maintain their productivity with untaxed or pretaxed dollars; we would be forced to do it with 65-cent dollars, and in our business, we wouldn't be in business very long. We would be out of business.

I submit that that would impact directly on the national defense and the national security. It would do nothing to help U.S.-flag shipping. It would help foreign controlled shipping. It would provide hardly anything in the way of revenues. Believe it or not, the estimate is somewhat less than $10 million a year; and the price of that would be losing 335 ships, which does not make any sense and really needs to be given very serious consideration.

There is another proposal which deals with the reciprocal treatment of foreign shipping income, of vessels coming into the ports of the United States, that also could impact on U.S. controlled shipping and even on U.S.-flag shipping and, of course, other shipping as well. Somehow, someone came up with the idea that we should change the rule that has pertained in shipping for 65 years—the rule that pertains throughout the free world, throughout the developed countries, and for that matter, throughout most of the developing countries. The proposed change would test a foreign ship coming into a U.S. port not on the basis of its flag, but on the basis of the residences of its ultimate owners and——

Senator **Chafee**. Why don't you stop right there, Mr. Loree? We will go over and vote and be right back.

Mr. **Loree**. All right. Thank you, Senator.

[Whereupon, at 11:40 a.m., the hearing was recessed.]

[The prepared written statement of Mr. Loree follows:]

STATEMENT OF PHILIP J. LOREE, CHAIRMAN
FEDERATION OF AMERICAN CONTROLLED SHIPPING (FACS)
BEFORE THE SENATE COMMITTEE ON FINANCE
ON CERTAIN PROVISIONS OF H.R. 3838 RELATING TO SHIPPING
FEBRUARY 4, 1986

I appreciate the opportunity to testify today on behalf of the Federation of American Controlled Shipping (FACS). The members of FACS are American companies owning (usually through foreign subsidiaries), managing or chartering merchant vessels registered under the laws of Liberia, Panama and The Bahamas.

My testimony will concentrate on certain provisions in H.R. 3838 relating to shipping which were not part of the Administration's tax reform proposals. (Indeed, the Administration's shipping tax proposals were directed only to the U.S. flag side of American shipping and would have impacted negatively on that fleet. We opposed that proposal for many of the same reasons stated herein.) Those provisions were incorporated during the final mark-up sessions of the Ways and Means Committee without benefit of prior testimony from interested parties outlining their potentially harmful effects.

We are most vitally concerned with the provision that would repeal the shipping reinvestment provisions of Subpart F of the Internal Revenue Code, thereby subjecting American companies to current U.S. taxation on the earnings of their foreign shipping subsidiaries even when those earnings are reinvested in shipping assets. This provision would severely disadvantage American shipowning companies which would have to compete against foreign shipowners still able to amortize loans and purchase new vessels with either untaxed or tax deferred earnings. Over a period of time American companies would be forced to phase out their fleets -- ships that are now subject to Effective U.S. Control and available to the

United States in the event of war and national emergency. The resulting loss of these vessels would negatively impact on U.S. national defense and national security interests. The repeal would not generate any meaningful new tax revenues (estimated to be less than $10 million per year) and would not benefit U.S. flag shipping. It would only benefit foreign controlled shipping.

We are also concerned with the proposed amendment to Section 883 of the Code that would make the residence of the ultimate owners (rather than the registries) of foreign registered vessels trading to and from U.S. ports the determining factor for granting or withholding the reciprocal exemption under that Section. Further, under proposed amendments to Section 863, vessel and vessel personnel income not qualifying for the reciprocal exemption would often be taxed at 4% of gross U.S. source transportation income (irrespective of ultimate profit) on the basis that revenues attributable to 50% of the voyages to or from U.S. ports were deemed to be U.S. source income, rather than revenues attributable to time actually spent in U.S. waters. In many cases these changes, in conjunction with the enactment of the new separate foreign tax credit limitation on shipping income, would subject American controlled shipping to significant additional U.S. taxation, in some cases where continuing operating losses exist.

Moreover, even where the American controlled foreign shipping corporation income qualified for reciprocal exemption, new withholding tax obligations on such an entity, as payor of charter hire or crew wages to non-exempt recipients, would greatly increase its costs. This would occur both because of the extreme burden and uncertainty of compliance and the presence of tax indemnification commitments under many existing contracts.

Finally, passage of this new tax on a greatly broadened basis and with a radically different and narrower exemption mechanism would create dangerous international precedents in that they would invite other nations, particularly developing nations without maritime fleets, to devise their own rules for taxation of vessels in their trades. Such actions would detrimentally affect the American controlled tonnage as well as U.S. flag tonnage in the future.

Proposed Repeal of Subpart F Shipping Reinvestment

A. International Competitiveness

Prior to enactment of the Tax Reduction Act of 1975, the earnings and profits of foreign flag shipping corporations* controlled by American enterprises were generally entitled to federal income tax deferral unless derived from dealings with affiliated parties _or_ actually remitted to the U.S. shareholders. Since 1975, however, earnings and profits have been subject to current federal income taxation regardless of whether they are remitted to American shareholders, except to the extent that they are reinvested in shipping assets. In this respect, over the past ten years U.S. controlled foreign flag shipping has been treated much more harshly under federal tax law than other U.S. controlled foreign corporations.**

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* This discussion assumes foreign incorporation of the shipowning entity, which is the usual practice.

** During this same period the number of American controlled vessels registered in open registry countries (and thus under Effective U.S. Control [EUSC] and subject to requisition, use or charter by the United States in an emergency) dropped from 468 vessels in 1975 to 335 vessels in 1985. While this decrease may be explained in large part by depressed shipping markets, the fact that the reinvestment option was the only alternative to current U.S. tax at times when there was little or no market demand warranting such reinvestment may well have been a contributing factor in encouraging American owners, particularly those with smaller fleets, to dispose of their vessels.

American controlled vessels must compete in highly competitive international shipping markets which are open to shipowners of all nationalities. The successful owners are those who can provide shipping services at the lowest costs, and yet, when market conditions dictate, be able to augment their fleets with modern, more efficient and more productive tonnage. The competition is so intense that any shipowning enterprise, regardless of nationality, which is disadvantaged in terms of construction, repair, operating or tax costs will eventually be forced out of the business.

Non-subsidized U.S. flag vessels have not been able to compete in these trades over the past half-century, if not longer. The American controlled foreign flag tonnage has been relatively competitive because the vessels are built and normally repaired abroad and are manned with foreign crews, so that their capital, repair and operating costs are on essentially the same level as most foreign controlled ships.

Up to the present, even with the 1975 amendment to Subpart F, American controlled shipping has maintained relative tax parity with its foreign competitors. In international shipping the tax treatment is basically the same for all competitive shipowning enterprises, regardless of their nationalities: they can use their earnings to amortize existing vessel loans and to invest in the acquisition of new vessels in order to meet market demand without incurring any immediate tax liability (and/or they are granted direct subsidies or other aids from their governments which enable them to accomplish essentially the same result). This is the competition which American shipowners must continue to be able to meet.

While tax deferral by itself offers no competitive advantage, its elimination would constitute a clearcut disadvantage in a capital intensive enterprise such as shipping. American companies controlling foreign vessels could only amortize existing loans and invest in new tonnage with income on which U.S. tax has been paid. In comparison, foreign controlled shipping would be able to respond to the changing needs of the marketplace by employing pre-tax or untaxed earnings to repay their loans and to make new capital investments designed to upgrade their fleets. Under these circumstances U.S. investments in international shipping could only decline. For many companies the logical choice would be to make no new investments, while gradually divesting themselves of their existing fleets over the periods of their useful lives. Those companies with proprietary cargoes would find it more economical to charter in lower cost foreign controlled tonnage.

These fundamental considerations were recognized by the House Ways and Means Committee in 1974, the last time it reviewed the question of deferral of shipping income under Subpart F prior to its deliberations in 1985. At that time, the House Committee unequivocally reached the conclusion that current taxation of shipping income was not a desirable objective when such income was targeted for reinvestment in shipping assets:

> "However, your committee recognizes that the competitive nature of shipping operations makes it diffcult to impose taxes on the profits of the foreign flag fleets of U.S. persons so long as the foreign flag fleets of other nations are not subject to any significant income taxes. The interests of the United States are best served if we have a significant U.S.-owned maritime fleet. To assume and maintain this status, large amounts of capital are necessary. Further, many U.S. investors in foreign shipping operations had their investments in such corporations 'locked in' by the corporations'

> financing arrangements and its need to retain amounts for repairs and maintenance. If the present exclusions were simply terminated and such income treated as constructively distributed to U.S. shareholders, the foreign corporation's ability to meet these obligations would be jeopardized. (Emphasis added.)

In the intervening years since the House Committee's report, the reasons for maintaining the competitiveness of American controlled tonnage have become even more compelling. International shipping is presently in the throes of a severe economic decline, with the demand for most types and sizes of vessels falling far short of the supply of such vessels. A growing number of companies have already phased out or sharply reduced their fleets, and because prospects for improved market conditions in the foreseeable future are not particularly bright, it is likely that further fleet phaseouts and reductions will occur.

Under conditions such as these, the reinvestment repeal provision in H.R. 3838, which would tax the earnings of American controlled tonnage more harshly than their foreign competitors is, at best, a cruel irony.

Indeed, in the economic climate prevailing in international shipping, it is questionable whether repeal of Subpart F would generate any tax revenues. The proposal has been optimistically estimated to produce $10 million per year in new tax payments over the next five years -- a fraction of the cost of subsidizing the building and operation of a single new ship.

B. Impact on U.S. Flag Shipping

To our knowledge the only group openly advocating repeal of Subpart F during the deliberations of the Ways and Means Committee was one of the maritime unions, presumably on the theory that eliminating the Effective U.S. Control fleet as an emergency sealift asset available to the United States in time of war or national emergency would strengthen their hand in seeking additional direct or indirect subsidies from the federal government for U.S. flag shipping. Whether or not this theory is valid, it hardly justifies such onerous tax treatment for American controlled shipping.

What is clear is that a decrease in American controlled tonnage would do absolutely nothing to improve the noncompetitive status of U.S. flag vessels in international shipping. Since the latter fleet demonstrably cannot compete against the foreign controlled vessels which make up more than 90% of the tonnage in the international nonliner trades, the removal of American controlled shipping as a competitive force in those trades could only benefit foreign controlled shipping.

C. National Security and National Defense

In 1962 the Committee on Finance examined the tax deferral accorded American controlled shipping and, in excepting income from the use of such vessels from foreign base company income, reported that "this exception was provided by your committee primarily in the interests of national defense." The Committee further reported that "In this regard it was believed desirable to encourage a U.S.-owned maritime fleet...operating abroad." The 1974 House Ways and Means Committee report referred to above expressed a similar view: "The interests of the United States are best served if we have a significant U.S.-owned maritime fleet."

This same conclusion pertains today, at a time when privately owned and commercially viable merchant shipping assets presently available to the United States are under severe constraints. The U.S. flag fleet is in a state of decline due to federal budgetary cutbacks, as well as problems associated with an aging and internationally noncompetitive fleet. The EUSC fleet, which is not dependent on federal supports, is relatively more modern, and is competitive in the world's bulk trades, is suffering primarily from the prolonged recession in international shipping markets.

Under the most ideal conditions U.S. emergency sealift needs would be covered by a sufficient number of modern U.S. flag merchant vessels of the desired types and sizes which are in active service, are owned, operated and manned by Americans, and are able to compete in commercial markets without government supports during peacetime.

Those ideal conditions, however, never have existed at any time throughout the Twentieth Century. With minor exceptions, U.S. flag vessels have not been able to compete in international shipping without direct or indirect subsidies, and such supports have usually been limited by budgetary and other economic pressures. This reality has compelled defense planners to look beyond the optimum and, based on a policy formulated by the Joint Chiefs of Staff, to rely on additional coverage from EUSC vessels which are controlled and operated by American companies and which presently fly the flags of Liberia, Panama, The Bahamas and Honduras. The EUSC policy and the vessels are described in more detail in the Appendix to this statement.

EUSC policy arose out of the problems created by the Neutrality Act of 1939 which barred U.S. flag ships from carrying essential supplies to Great Britain and France. The policy has been supported by every Administration since that date, and has been tested in World War II and Korea and on a commercial basis during the Viet Nam conflict. Secretary of Defense Caspar W. Weinberger's comments on this policy, following a review by his Department in 1981, are typical:

> "The EUSC fleet is composed of some 465* ships primarily under Liberian registry with a few under Panamanian and Honduran flags.** These ships, owned or controlled by U.S. citizens, are considered in contingency plans for sealift requirements primarily as a source of ships to move essential oil and bulk cargoes in support of the national economy. The majority of these vessels are not considered militarily useful.
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> "The EUSC countries of registry have stated that they will assert no control over the employment of ships on their registries, and that they will not interfere with the exercise of emergency authority by the governments of shipowners. They have indicated, with varying degrees of formality, that they would not interpose any objections to the exercise of U.S. requisitioning authority over U.S. owned ships.
>
> "While there are other forms of control exercised by the Government over foreign registered ships, the real basis for the effective U.S. control concept is the authority provided by Section 902(a) of the Merchant Marine Act of 1936 which authorizes the Secretary of Commerce to requisition ships in time of war or national emergency regardless of registry. There have been no formal treaties executed with the countries of EUSC registry. Although we do not consider their crews as reliable as U.S. crews, we have no basis to believe that most of the ships in question would not be made available when needed."

In correspondence with Secretary of Transportation Elizabeth Dole dated April 24, 1984, Secretary Weinberger warned of the decline in merchant shipping capable of supporting national security objectives, and expressed concern with respect to whether those assets were capable of meeting military needs and the "requirements of the civil economy and industrial base" during a major conflict. He attached a paper on Department of Defense Dry Cargo Shipping Objectives and Requirements which stated the "minimum" policy objective to be "... to maintain sufficient shipping capacity under U.S. government control and/or in the U.S. commercial fleet to meet the surge and sustaining requirements of that portion of a global war wherein allied shipping is not available." A footnote to this statement explained that "The U.S. commercial fleet is defined to include ships registered under U.S. flag and effective U.S. controlled (EUSC) ships owned by U.S. citizens and registered under foreign flags of convenience."

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* Now reduced to 335.

** And now Bahamian.

The EUSC fleet offers some unique advantages as a supplement to available U.S. flag tonnage. They are, as noted earlier, not subject to federal budgetary constraints. They are, for the most part, in active service and at any given time are dispersed throughout the world, with many deployed in the U.S. import/export trades. In addition, the EUSC fleet is, on average, much younger in age and thus modern in design and productivity. Unlike NATO vessels, they are operated by American companies based in the United States, and can be brought under direct control of U.S. defense officials through requisition, use or charter, with the approval in advance of the flag states and under the authority of Section 902 of the Merchant Marine Act of 1936, as amended. Also unlike NATO vessels, their availability is not questionable in emergencies where U.S. actions are not supported by its NATO partners.

The flag states are closely aligned with U.S. policy interests, have neither the reason nor the means to requisition the vessels for their own uses, and accept, either explicity (in their laws or regulations) or tacitly, that such vessels are subject to requisition, use or charter in event of war or national emergency. In addition, vessels are readily transferable from any of those registries in the event that particular circumstances make such transfers desirable.

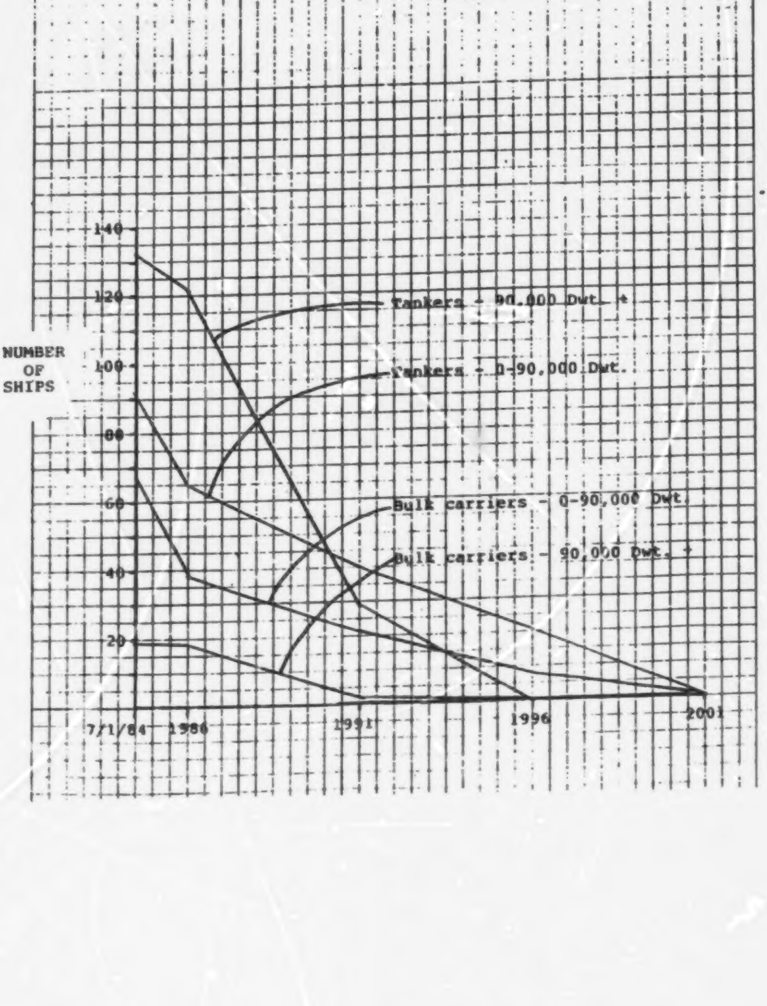
Depending on their sizes and types, some EUSC vessels have a national defense utility and others a national security utility:

(1) Almost 40% of the vessels can be utilized under emergency conditions for direct and indirect military support. These include tankers up to 90,000 dwt., as well as general cargo vessels and refrigerated cargo vessels. It is also possible that under extreme conditions geared Panamax bulkers up to 90,000 dwt. could, with some alterations, likewise be utilized.

(2) Most of the remaining vessels (predominantly large tankers, bulkers and combination vessels) can be deployed to maintain the flow of strategic raw materials from abroad in support of the U.S. economy. In effect, many of these vessels would simply continue to perform the same services that they provide during peacetime. It might well be necessary to call upon some to replace U.S. flag vessels in the domestic trades (e.g., oil from Alaska) in the event that the latter were redeployed elsewhere. Very large tankers could also be positioned in strategic locations as oil storage facilities, as some are today.

If, as explained earlier, the American companies controlling EUSC vessels are placed at a tax disadvantage in a highly competitive international marketplace, they would have no meaningful incentive to continue investing money in new vessels. At best, the incentive would be to continue to operate their existing fleets throughout their useful lives, and then, in most cases, abandon future business to foreign owners. Under this scenario, taking into account the present age distributions of EUSC vessels, the tanker and bulk fleets now under Effective U.S. Control would soon diminish in number and disappear, as shown in the following graph:

NUMBER OF EUSC
TANKERS AND BULK CARRIERS
(INCLUDING COMBINATION VESSELS)
7/1/84 - 2001



The repeal of the Subpart F reinvestment provisions would, as the above graph depicts, steadily reduce the future sealift emergency assets under Effective U.S. Control which are presently available to the United States. In this regard, we urge your Committee to solicit the views of Department of Defense officials as to whether such repeal would be inimical to the nation's national defense and national security interests. We believe that defense officials will reaffirm that such repeal would be contrary to important U.S. interests, and should be opposed.

Proposed Changes Relating to Ownership of Vessels and Sourcing of Income

Over the past sixty-five years the United States has followed the internationally accepted practice of not taxing foreign flag vessels trading to or from U.S. ports provided that the nations of registry do not tax U.S. flag vessels trading to or from their ports. With respect to the limited number of vessels not qualifying for this reciprocal exemption, the United States has, in accordance with customary international practice, treated only that portion of income which is, generally speaking, attributable to time spent in U.S. waters as U.S. source income and thus subject to U.S. tax.

This system of tax forbearance has been adhered to by virtually all of the major trading nations of the Free World, and with a few minor exceptions, by most other nations as well. Underlying this international practice has been the general recognition that if individual nations unilaterally taxed foreign vessels visiting their ports, the practice would spread, international shipping would become more costly, less efficient and less productive, and consequently trade among nations would be impeded.

If an increasing number of nations, particularly the developing countries of the world, decided to impose their own particular concepts of taxation on vessels trading to or from their ports, the results could be chaotic for international shipping. This is so because the tax systems in other nations of the world do not necessarily recognize the same deductions, credits and income source rules that are recognized under U.S. tax laws. In this regard, the United Nations Department of Economic and Social Affairs pointed out a number of years ago that "if every country taxed a portion of the profits of a shipping line, computed according to its own rules, the sum of those operations might well exceed the income of the enterprise." The problem would be compounded for vessels which call at a series of ports in different tax jurisdictions during any one voyage -- a common practice in international shipping.

It is against this background and experience that we view a number of seemingly innocuous provisions adopted by the Ways and Means Committee as inherently threatening to our industry. First of all, a proposed amendment to Section 863 would enlarge the definition of transportation income to include not only shipping services income but passive leasing income earned on the rental of vessels, aircraft and containers and personal service income of shipboard personnel. Secondly, another proposed amendment to Section 863 would change the definition of United States source income to be 50% of income attributable to any voyage leg involving a United States port receiving or sending cargo or passengers determined on an item by item or person by person basis. Finally, a 4% withholding tax would be imposed on such United States source gross transportation income which is not effectively connected with a United States trade or business (as newly and very narrowly defined for this purpose) or which is not shown to have been previously subjected to this tax as it cascaded through various earlier foreign taxpayers.

Exemption from tax on such United States source transportation income would be determined by a radically amended provision which would look not to registry of the vessels but to the ultimate residence jurisdiction(s) of the foreign taxpayer(s) involved. If 25% or more of the value of the stock of a foreign corporation formed in a reciprocal exemption jurisdiction is ultimately owned by individuals who are not residents either of that foreign country or another foreign country qualifying for reciprocal exemption, the exemption would not apply. United States shareholders owning 10% or more of the voting stock of Subpart F controlled foreign corporations formed in a reciprocal exemption jurisdiction would, however, be deemed to be residents of the country of incorporation, presumably to avoid possible double current taxation, i.e., direct and indirect, of transportation income. Where there are less than 10% owning United States shareholders and/or there are non-qualifying foreign shareholders who in the aggregate own 25% or more, however, the exemption would be lost and double taxation would occur.

Moreover, foreign corporations widely held by United States and foreign shareholders would not be able to establish qualification so as to be eligible for exemption. Such corporations and non-qualifying controlled foreign corporations would suffer taxation, in the case of the 4% gross levy, irrespective of any continuing operating losses. Any tax so incurred, unlike the analogous imposition of a United States branch tax on a foreign corporation engaged in trade or business in the United States, would not be eligible for the deemed paid foreign tax credit and any foreign tax arising as a result of retaliatory taxation of United States flag or U.S. controlled foreign flag shipping would only be creditable within the newly created shipping income basket establishing a separate foreign tax credit limitation.

In addition, even American controlled foreign shipping corporations qualifying for the reciprocal exemption would face heavily increased costs arising from the onerous compliance burdens placed upon them as putative withholding agents in respect of charter hire and crew wages payable by them where some (not easily) determined segment thereof is United States transportation income. Moreover, where withholding of tax is accomplished with respect to charter hire, for example, underlying contractual agreements either already or would in the future provide for a reimbursement for such tax so that the payor would ultimately bear the economic burden even where it is itself exempt and only acting as a withholding agent.

The only plausible reason for this radical departure from customary international tax practice is an attempt to impose a tax on a small number of vessels flying the flags of nations entitled to the reciprocal exemption under Section 883 but which are indirectly owned by residents of a handful of developing countries, located primarily in Asia, which impose gross receipts taxes on vessels, including some U.S. flag liner vessels, trading to and from their ports. In reality, the number of vessels falling into this category represent, at most, a tiny fraction of the roughly 29,000 foreign vessels that enter U.S. ports in a typical year. With respect to those few vessels, it is unlikely that a test based on ultimate ownership would be workable or effective, since intervening corporate tiers, bearer shares and other devices would probably be used to shield the identity of the ultimate owners.

We believe that the proposed changes would only encourage other nations, particularly developing countries without substantial merchant fleets, to believe that they are entitled to tax a percentage (possibly even 100%) of revenues of vessels entering their ports. That practice, if it became widespread, could be most harmful to legitimate shipowning interests throughout the world, including American controlled and U.S. flag shipping. It is primarily for their dangerous precedential value that we believe that these proposals are ill-founded and ill-advised.

Conclusion

For the reasons outlined above we respectfully urge that your Committee reject the provisions in H.R. 3838 that (1) would repeal the shipping reinvestment provisions of Subpart F of the Code, (2) would revise the definition and sourcing of shipping income rules under Section 863 of the Code, (3) would impose a new 4% withholding tax on U.S. source gross transportation income and revise the reciprocal exemption rules under Section 883 of the Code, and (4) would establish a new separate foreign tax credit limitation for shipping income.

APPENDIX

The Development of EUSC Policy

The history of EUSC policy dates back to the early days of World War II when American companies, acting at the request of the United States government, made available their Panamanian, Honduran and Venezuelan flag ships as part of the effort to supply Great Britain and France with essential supplies, a trade barred to American flag ships by the Neutrality Act of 1939. At the same time, the government encouraged transfers to Panamanian registry -- an action which gave birth to the U.S. effective control concept. By July 1941 there were 111 vessels of more than 1 million deadweight tons under effective U.S. control, including 88 tankers aggregating over 950,000 deadweight tons.

Later, when the United States entered World War II, effective U.S. control ships joined with the American merchant marine in the war effort, including the famous convoys to Murmansk. During the war many were sunk by enemy action. One American company alone lost 19 ships, while another operator lost 17 vessels.

As reported in a U.S. Department of Commerce study, it was during World War II that the term "effective control" was actually adopted by the War Shipping Administration to differentiate between ships operating under U.S. flag and those under foreign flags, principally Panamanian. The same governmental study points out that the present effective U.S. control policy was developed originally by the Joint Chiefs of Staff.

In 1945, the Joint Chiefs of Staff considered the role of U.S. merchant shipping as an instrument of national defense as follows:

> "To be effective as an instrument of national defense U.S. merchant shipping should be under U.S. flag or effective U.S. control and should be of such capacity that it is able to absorb substantial initial losses which may be occasioned by either a surprise attack or an efficient submarine and air interdiction of sea lanes, or both, and still perform the following services:
>
> a. Provide logistic support for forces of the U.S. which may be overseas at the time of the emergency.
> b. Transport U.S. forces to overseas destinations and maintain such forces.
> c. Maintain the economic war making capacity of the country." (Emphasis added)

At the same time, the Joint Chiefs of Staff also defined effective U.S. control:

> "The term 'effective United States control' as applied to shipping is considered to include all shipping which can be expected to be available for requisition by the United States Government in time of national emergency even though such shipping may not be under the United States flag. When ships earmarked for the National Defense pool are chartered by agencies other than United States nationals, agreements should be made to return these ships to United States Government control if required for war or emergency purposes."
> (J.C.S. 1454/1)

In 1947, the Joint Chiefs of Staff expanded and clarified that definition as follows:

> "The term 'effective United States control' as used [in J.C.S. 1454/1] appears to be inadequately defined. On a number of occasions doubt as to the meaning of the term has arisen. Except through agreement there are no legal means by which the United States can regain control of a United States merchant vessel the registry of which has been transferred to another country. From a legal standpoint therefore it can be considered that the only time a vessel is under absolute 'effective United States control' is when it flies the United States flag. Actually, however, there are certain countries in this hemisphere which through diplomatic or other arrangements will permit the transfer to their registry of United States ships owned by United States citizens or United States corporations and allow these citizens or corporations to retain control of these vessels. Prior to entry of the United States into World War II, United States vessels were transferred to Panamanian registry for the purpose of rendering aid to the allies. Such a case as the above can be considered to be within the meaning of the term 'effective United States control'. When the foreign authorities who are in a position to dictate to the owner, master, crew, charterer or other individual or agency having physical control of the vessel are willing and able to bring the vessel under control of the

> United States in an emergency for such use as the United States may wish to make of the vessel, such vessel may also be considered to be under 'effective United States control'. It can be concluded, therefore, that the primary considerations in determining whether or not a United States merchant ship registered under a foreign flag would still be under 'effective United States control' are:
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> a. The practice followed in the past in regard to transfer of United States merchant vessels to foreign registry.
>
> b. The status of diplomatic relations between the United States and the foreign country concerned.
>
> c. Its relations with countries opposed to our system of government or foreign policy.
>
> d. Proximity of the foreign country to the United States.
>
> e. The stability of its government."
>
> (J.C.S. 1454/11)

In 1959 the National Academy of Sciences-National Research Council in a study entitled "The Role of the U.S. Merchant Marine in National Security" (Project WALRUS) had the following to say about effective U.S. control:

> "For purposes of indisputable control, it would be preferable that all U.S.-owned merchant shipping be documented under U.S. flag. Such an ideal situation does not exist. At the same time, U.S. flag merchant tonnage is not adequate to meet our total wartime needs. This is particularly true with tankers, as about half of the U.S.-owned tanker tonnage is registered under foreign flags.
>
> "In the event of war it will be necessary to augment U.S. flag shipping. The Maritime Administration and the Navy Department have determined jointly that it will be practicable to bring a portion of the U.S.-owned foreign-flag shipping under direct U.S. control in the event of a national emergency. This effective U.S. control concept is a matter of expediency, rather than choice, and applies essentially to designated shipping under the 'flags of convenience.'

"Determinations regarding effective control are not founded on governmental treaties. Assurances that specific ships will revert to U.S. control are given by the U.S. owners of the ships, not by the country of registry. Former U.S. flag vessels that were transferred to PANLIBHON registry are under effective control as a result of stipulations in the transfer contract approvals granted by the Maritime Administration. Less formal agreements apply to foreign-built shipping.

"U.S. owners can register foreign-built shipping under any friendly flag of their choice, or transfer from one flag to another at will. In the case of foreign-built PANLIBHON-flag ships, the Maritime Administration normally negotiates agreements with the U.S. parent companies that the ships will be made available to the United States in the event of a national emergency.

"Ships' crews must also be considered in making plans for implementation of effective control. The crews of ships under PANLIBHON flags are all nationals of countries friendly to the United States. The majority are nationals of NATO countries. On the outbreak of an emergency, ships would be routed to selected points for proper screening of personnel -- and replacement where appropriate. Dependent upon individual ship locations on the outbreak of an emergency, it is possible that some of the foreign crews may defect and deliver a few PANLIBHON ships into enemy hands. In the event of a NATO war it is also possible that some European crews may ignore the orders of U.S. shipowners and deliver ships to ports of the countries from which they were employed. In the latter case, such ships would still support the common NATO effort and their employment would be governed by NATO pooling and allocation procedures.

"Soundness of Effective Control under PANLIBHON Flags. The absence of operational control restrictions in the existing maritime laws of PANLIBHON governments permits the exercise of effective U.S. control without restraint. Additionally, the ocean shipping requirements of these small, friendly countries are limited and they would be unlikely to

> requisition ships for their own use in the event of war. Other factors that contribute to the soundness of our effective U.S. control concept are:
>
> (a) The natural bond of U.S. ownership and allegiance is augmented by written agreement between the shipowners and the U.S. government.
>
> (b) The small PANLIBHON countries possess limited capabilities to both operate and maintain sizable merchant fleets. Ships under their flags usually ply the world's trade routes and have rare occasion to put into ports of their registries.
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> (c) PANLIBHON countries possess negligible capability to intercept, seize, or protect shipping on the high seas. Consequently, these nations are not in a position to expropriate U.S. property afloat or to dispute U.S. assumption of control over selected shipping.
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> (d) The United States possesses a definite and sizable capability to protect shipping at sea. Thus, the United States has both the power and the intent, in event of a national emergency, to consummate agreements with individual shipowners in respect to designated shipping registered under PANLIBHON flags.
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> (e) Further, during any national emergency declared by proclamation of the President, Section 902 of the Merchant Marine Act of 1936 empowers the Federal Maritime Board to requisition or purchase any vessel owned by citizens of the United States. U.S. rights under Section 902 are stipulated in all Maritime Administration approvals of transfer to PANLIBHON flags.
>
> (f) It appears logical to assume that U.S. citizen-owned ships registered under PANLIBHON flags, for which effective U.S. control agreements exist, would, in the event of a national emergency, gravitate towards a United States protective umbrella for self-preservation. To refuse would probably lead to considerable difficulty in the procurement of war risk insurance."

Also in 1959, then Under Secretary of State C. Douglas Dillon described U.S. policy before an Intergovernmental Shipping Conference:

> "My final thought on this subject is that, until such time as it may be feasible for these American shipowners to operate competitively under the United States flag, my Government retains its interest in the continued operation of ships under foreign flags, including the PANLIBHON registries. From our viewpoint there are important and valid defense requirements which support this position."

Since World War II there has not been a national emergency which required the requisitioning of effective U.S. control vessels or, for that matter, American flag vessels. Nevertheless, effective U.S. control vessels have been credited with aiding the nation's sealift requirements during the Korean and Vietnamese conflicts. During the Korean war American companies committed both their U.S. flag and foreign flag vessels to the voluntary tanker pool, and effective U.S. control vessels were credited with making most of the foreign tanker voyages under the voluntary tanker plan. In December 1960 the Office of Civil and Defense Mobilization reported:

> "... in practice during World War II and Korea, when the United States called on privately-owned tonnage to meet defense needs, PANLIBHON (Meaning Panamanian, Liberian and Honduran flag) vessels subject to emergency utilization by the United States were immediately made available. In neither case did serious problems develop because of the foreign nationality of the crews."

Throughout the Vietnam conflict U.S. effective control tankers were engaged in the carraige of essential petroleum products to South Vietnam on a commercial basis. For example, a 1967 study showed that during the 12-month period ending March 31, 1967 effective U.S. control tankers made 61 voyages to or between South Vietnamese ports, delivering more than 5-1/2 million barrels of petroleum products. During this same period these same ships spent an aggregate of 429 days in Vietnamese waters on floating storage or shuttle service duty, transferring petroleum products to and from other tankers, including MSTS vessels.

One of the strongest arguments in favor of effective U.S. control policy is past performance. In testimony during March 1966, Maritime Administrator Nicholas Johnson, speaking of U.S. effective control policy, said:

> "Certainly if the history of the Second World War and Korea is valid for purposes of future planning, history is on the side of this judgment. As a practical matter these ships have been available to the United States when needed." (emphasis added)

He also said:

> "The government believes these ships to be subject to the 'effective control' of the United States under emergency conditions. We are not now talking about ships owned by foreign citizens and registered in foreign countries -- which have in a small number of cases refused to carry our defense cargoes-but ships owned by American citizens. We are talking of plans that, by and large, those ships will continue to serve the raw materials import trades that they now serve-although some of them would be directly involved in the defense effort (and are today)." (emphasis added)

It should be added that no crews on effective U.S. control vessels refused to sail during World War II, the Korean conflict or at any time during the Vietnam conflict. This may explain why during 1967 Secretary of Defense Robert S. McNamara stated:

> "In a full scale national emergency, we believe 'effective U.S. controlled' ships will be as available to DoD (Department of Defense) as U.S. flag ships."

This policy of reliance on the fleet as a supplement to U.S. flag vessels continues to the present. In July 1977, for example, Vice Admiral Edward W. Cooke, Deputy Chief of Naval Operations for Logistics, U.S. Navy, testified as follows on the subject of effective U.S. control policy:

> "In case of mobilization, we believe those ships will be available. There is a contractual control, based on war risk insurance, but beyond that, there is the fact that they are U.S.-owned in case of mobilization. We believe they would be available for U.S. forces." (Hearings before the Committee on Merchant Marine and Fisheries, Serial No. 95-12)

Similarly, Admiral James L. Holloway III, Chief of Naval Operations, in his policy statement dated March 1, 1978 on the Navy's military and budget postures confirmed that:

> "The United States has plans for the utilization of foreign flag ships of the Effective U.S. Control (EUSC) Fleet. These are U.S.-owned or U.S. controlled ships of foreign registry of 1,000 gross tons or more, which are under contract to the Maritime Administration. These can reasonably be expected to be made available for U.S. use in time of emergency."

More recently, Everett Pyatt, Principal Deputy Assistant Secretary of the Navy, Logistics, testified on December 11, 1979 that:

> "We would expect that foreign-flag vessels owned or controlled by U.S. citizens would be made available to the U.S. in time of national emergency. Although all might not be able to respond in time of need, we have no reason to believe that a significant amount would not be placed at the disposal of the U.S."

On June 8, 1981, Secretary of Defense Caspar W. Weinberger replied to a request of the National Maritime Council asking that the Department of Defense undertake "a thorough review of the validity of the 'effective control' concept." In its letter the NMC raised questions as to the availability and reliability of the vessels in the event of an emergency and cited the possibility of flag state intervention if the United States sought to utilize the vessels. Secretary Weinberger's letter advised that the Department of Defense had, in fact, reviewed the effective control concept as NMC requested and offered the following evaluation:

> "The EUSC fleet is composed of some 465 ships primarily under Liberian registry with a few under Panamanian and Honduran flags. These ships, owned or controlled by U.S. citizens, are considered in contingency plans for sealift requirements primarily as a source of ships to move essential oil and bulk cargoes in support of the national economy. The majority of these vessels are not considered militarily useful.
>
> "The EUSC countries of registry have stated that they will assert no control over the employment of ships on their registries, and that they will not interfere with the exercise of emergency authority by the governments of shipowners. They have indicated, with varying degrees of formality, that they would not interpose any objections to the exercise of U.S. requisitioning authority over U.S. owned ships.
>
> "While there are other forms of control exercised by the Government over foreign registered ships, the real basis for the effective U.S. control concept is the authority provided by Section 902(a) of the Merchant Marine Act of 1936 which authorizes the Secretary of Commerce to requisition ships in time of war or national emergency regardless of registry. There have been no formal treaties executed with the countries of EUSC registry. Although we do not consider their crews as reliable as U.S. crews, we have no basis to believe that most of the ships in question would not be made available when needed."

The most recent assessment came from Captain R. W. Kesteloot, Director of Strategic Sealift, Office of the Chief of Naval Operations, on March 7, 1985, when he testified before the Subcommittee on Seapower and Force Projection of the Senate Armed Services Committee. The following are his comments on the U.S. effective control fleet, given in response to questions by Senator William S. Cohen (R-Me.):

> "Senator Cohen: You mentioned there are ships that would be in addition to the strategic reserve ships under effective U.S. control. What are these ships? Where are they? What are they?
>
> "Captain Kesteloot: The ships that are under effective U.S. control are frequently referred to as EUSC ships. These ships are requisitionable assets available to the U.S. Government in time of national emergency. They are ships majority-owned by U.S. businesses operating under the registries of four nations, Liberia, Panama, Honduras, and The Bahamas. These four countries, unlike most others, do not have laws which preclude or limit requisitioning. EUSC ships number over 400, but only 23 dry cargo, and 57 tankers are considered militarily useful.

STATISTICS

The following table, based on preliminary data from the Maritime Administration, describes the foreign flag vessels owned or controlled by U.S. companies as of July 1, 1985. The EUSC fleet has 335 vessels and there are 101 ships registered in 17 other countries.

	Tankers		Freighters		Bulk & Combo	
	No. Ships	Dwt.	No. Ships	Dwt.	No. Ships	Dwt.
Liberia	163	27,517,427	19	217,938	60	3,090,028
Panama	39	4,631,170	16	67,226	12	330,431
Bahamas	21	4,150,339	--	--	1	128,320
Honduras	--	--	4	24,975	--	--
Other (17 Countries)	72	5,302,379	15	47,617	14	873,159

Based on this preliminary data, the EUSC fleet has diminished by 67 ships, or 17%, in the year since July 1, 1984.

AFTER RECESS

Senator **Chafee**. Senator Moynihan, do you have some questions for the panel?

Senator **Moynihan**. Mr. Chairman, I don't have specific questions because of the very nature of the testimony which has to do with propositions that were not in the President's proposal. We had a lot of hearings on the President's proposal last year, but not on any of these subjects.

But there are two points I would like to make. I was a little chilled to read in Mr. Langdon's report that in 1980 electronic companies produced a $7.4 billion trade surplus, which by 1984 had become a $6.2 billion deficit. Wow. I mean, when you are in trouble, we are all in trouble.

I would like to say, and I think the chairman knows this, that there is no organization that is better regarded for its objectivity in these matters than the Emergency Committee for American Trade. ECAT is an old friend of this body. And we listened to Mr. Wiacek with great attention. And Mr. Loree, your case was made forcibly as well. Would it not be possible to ask our staff to give us an assessment of the impact of the legislation we have from the House on trade matters? Don't you think we ought to look at that?

I mean, we hear these things. They seemed to have come up very much at the end, and I think Mr. Langdon, it was you who used the term that they were resource driven. Was it not you, sir? Or was it Mr. Wiacek. That getting this to become revenue neutral might bind any provision, and it might end up doing us real disservice in the trade field.

Senator **Chafee**. What I would suggest, Senator Moynihan—I share with you your concern over the adverse trade impacts of the legislation that the House has passed without any hearings. Why don't I discuss this with the chairman. And I think that, if it is agreeable with the chairman, we might have some more hearings on these particular issues—this last-minute legislation that came zipping through the House, that was tacked on, as they said, to gain some revenue. Why don't we do that? I will talk with the chairman about it.

Senator **Moynihan**. Yes. Let's do that. For my part, I want to thank you. I mean, we didn't have the least idea of some of these things, and now we do.

Senator **Chafee**. Let me just say to Mr. Langdon and Mr. Wiacek and Mr. Loree all that I share the concerns you have; and of course, I have been familiar with the AEA for a long time and what you folks have done to try and encourage exports and make us more competitive.

Now, let's talk briefly about this section 482 and the audit practice. Could this be changed in some way to correct the problems with things like intangibles, royalties, in the House bill without going as far as the House did?

Mr. **Langdon**. Yes, I suppose we could come up with some sort of formula to enforce arm's-length royalties. The trouble with the House bill is that it looked at one extreme of alleged abuse, and maybe that occurs, and tried to tailor the whole world around that. We are currently only about 2 or 3 years into the current amendment, the 367(d), which requires that all intangibles be transferred on an arm's-length basis. Prior to that, you could make 351 tax-free transfers of intangibles abroad. And I would submit that we really don't have a sufficient track record or an ability on the part of the IRS to enforce existing law without going into an extreme position, like in the House bill.

Our company has always collected royalties on transfers of intangibles abroad. Not all industries in the United States have done that, but I would submit that we apply the existing standards and see how we work out without coming up with a new standard that is not accepted by other foreign governments. The key thing that really stops large royalty repatriations from abroad are foreign governments who really don't want those amounts remitted out of their countries.

Senator Chafee. OK. I am going to ask you and Mr. Wiacek two quick questions. One: In the House, they didn't stick with the 25-percent R&D tax credit; they went to the 20 percent.

Mr. Langdon. Yes.

Senator Chafee. And they made it 3 years.

Mr. Langdon. Right.

Senator Chafee. Second, on the capital gains——

Mr. Langdon. The rate went up from 20 to 22 percent.

Senator Chafee. All right. In your outline, you say those points are very important.

Mr. Langdon. Yes.

Senator Chafee. I will take the second one first. How important really is the difference between 22 and 20 on the capital gains?

Mr. Langdon. Obviously, it is not as large as where the capital gains rate was under prior tax law. It is an important factor, and we certainly favor the restoration to the 20-percent rate.

Senator Chafee. But also, you want the rates reduced.

Mr. Langdon. Right.

Senator Chafee. You would prefer to have the 33 maximum that you would 40 or whatever Hewlett-Packard is paying. We have had a parade of witnesses who have done a good job here today, each one saying restore some kind of a tax credit or whatever it was that the House eliminated. If you added them all up, I don't know what the price would be.

Mr. Langdon. Yes.

Senator Chafee. But where are we going to get the money if we are trying to keep these rates at 33 or 35 for individuals? OK. Now, on a scale of 1 to 10, where do you put the 22-percent capital gains?

Mr. Langdon. Assuming that 10 is the highest——

Senator Chafee. Ten is the most important.

Mr. Langdon. Well, I guess we would rate it as a five or a six. The R&D credit is perhaps more——

Senator Chafee. Now, let's go to that one.

Mr. Langdon. Yes. It is more important to us. We would rate that a 9 or a 10. The reason is that it was cut—not only was it cut by 20 percent, but in addition, it was only put in place for 3 years; and we feel that that is inappropriate.

Senator Chafee. I know that has constantly been a struggle here. I remember speaking to the AEA a long time ago and said:

Don't worry; that will all be taken care of; and of course, it wasn't. OK. What do you have to say, Mr. Wiacek?

Mr. **Wiacek**. I would like to say that, as was said by a number of witnesses that were here this summer, the rate reduction doesn't come near offsetting the base broadening that has gone on. There has been a $140 billion shift from the individual to the corporate sector. On the international side, what I would like to repeat is that, as you know, this is a place where you can't level the playing field because you don't control it.

I ask you, with trade in mind, is this the sector from which you want to get the revenue to help balance out the rest of the bill? And if so, do you think that our foreign trading partners are going to enact similar provisions any time soon? And if not, won't our companies be facing——

Senator **Chafee**. Excuse me 1 second, please.

Mr. **Wiacek**. Won't our companies be facing novel taxes not faced by their competitors, which are intended to raise billions of additional dollars in taxation not faced by their competitors?

Senator **Chafee**. Let me just get back to these two points again quickly because we have got limited time and we have two other witnesses. I know you are not AEA, but what about the capital gains?

Mr. **Wiacek**. The capital gains is primarily important to entrepreneurial or high technical companies that rely on it to raise money, and those type of companies include many ECAT members. But ECAT, of course, also consists of the mainstream industrials. The capital gains taxation is an important provision, but I probably agree with my colleague that it is in the four, five, six range. It is there; it is important, but——

Senator **Chafee**. Again, what about the R&D tax credit, although I suppose you are not so much into that?

Mr. **Wiacek**. As a matter of fact, Mr. Langdon is a member of ECAT, as are other electronics companies, pharmaceutical companies, and others that are high tech, so the R&D credit is important. I don't know that I would put it at a 9 or a 10, but I would certainly put it between 5 and 10. I think, in fact, one of the issues you are going to see up here as the most controversial is the 367/482 issue. It arose very, very late in the game on the House side. In fact, it was a one-line sentence in the middle of the 936 Puerto Rican proposals. No hearings; nothing.

Senator **Chafee**. All right. What about the problems you mentioned about the increased burden on domestic companies with foreign operations? Is that neutralized to some degree by the lowering of the corporate rates?

Mr. **Wiacek**. No, I don't think so. We heard that argument from the Joint Committee. It is a bit like someone telling you: Take this; it is good for you. Or: This won't hurt a bit. We didn't ask for this.

Senator **Chafee**. Would you rather have no tax bill than the House one, even if the House one were fixed up to some degree, along the lines you have heard suggested?

Mr. **Wiacek**. Speaking personally, Yes. I think that is the case.

Senator **Chafee**. Would you prefer present law?

Mr. **Wiacek**. I would prefer present law. Yes.

Senator **Chafee**. What do you say, Mr. Langdon?

Mr. LANGDON. With some minor changes that we have suggested we would favor tax reform.

Senator CHAFEE. All right. Mr. Loree.

Mr. LOREE. Well——

Senator CHAFEE. You represent U.S.-owned foreign flag ships. Who do you pay taxes to, if anybody?

Mr. LOREE. Well, we pay taxes to the United States when earnings and profits are remitted to the U.S. shareholders. We pay tonnage taxes to the nations of registry. I would say, in that respect, we are no different than any other shipowner against whom we are competing.

It has been said about shipping—you have probably heard it said—that economists have called it a taxless world. That is true, I suspect, in terms of immediate taxation on earnings or profits, assuming there are any; but the fact is, for U.S. shareholders, unless we reinvest in shipping assets, under the law as it is now, we are taxed currently even if the dividends aren't remitted to the U.S. shareholders.

Shipping is treated differently. Shipping is in Subpart F the only active business—and believe me, it is an active business—that is included with various kinds of passive activities. Shipping income is treated competely differently. Unless we reinvest, we pay taxes.

Senator CHAFEE. You have cited three provisions you didn't like. In order of your distaste for them, which is the worst and the best?

Mr. LOREE. If the top of the scale is 10, then I give repeal of the Subpart F reinvestment provision a 15 because it would put us out of business. It is that simple. Sections 833 and 863 present all kinds of problems that I don't believe people understand where, in certain situations, owners would have to investigate the residence of each of the crew members and withhold wages based on what legs of voyages involved U.S. ports. It is that strange. It is a bureaucratic morass that would accomplish nothing and would impel developing countries, which do not have their own merchant fleets, to do the same thing. And to me, that could be utter chaos for our business.

Senator CHAFEE. You are not for it? OK. Senator Moynihan.

Senator MOYNIHAN. Mr. Chairman, just a capital gains question. We went through that in 1977 and 1978, and we did cut the capital gains; and I think it is one of the few examples where the response was pretty much what was predicted. Revenues rose. And I think Mr. Langdon testified to the effect, from the electronics industry at the time, having spent all our time cutting capital gains, now to start raising them is an example of what we seemed to have gotten ourselves into in this legislation. Mr. Chairman, I must regretfully tell you that we are having a party caucus at this hour to decide what is going to happen to our Gramm-Rudman. So, if you will forgive me, I am going to have to let you take the rest of this hearing.

Senator CHAFEE. All right, as long as you report back to us. [Laughter.]

Fine. Thank you all very much, and please convey our good wishes to Mr. John Young, who has testified here and who did a good job on that report.

All right. Mr. Fred Wertheimer and Mr. Thomas Ruhm.

Why don't those who are leaving leave very quietly, and Mr. Wertheimer, why don't you start? We welcome you here.

STATEMENT OF FRED WERTHEIMER, PRESIDENT, COMMON CAUSE

Mr. **Wertheimer**. Thank you, Mr. Chairman. Our testimony deals with two provisions of the House tax bill. We are opposed to the 100-percent tax credit for political contributions that was passed as part of the House bill. We support the dollar tax checkoff for Presidential elections, which was repealed in President Reagan's tax proposal but retained in the House bill.

The 100-percent tax credit for political contributions was rejected in the House Ways and Means Committee by a 14-to-21 vote and then passed on the House floor by a margin of 230 to 196 votes. We opposed the 100-percent tax credit by itself for three reasons.

One, it is not the remedy to what we consider the single biggest problem in the field of congressional campaign financing, and that is the role that PAC's are playing in the political process. We don't believe there is any realistic reason to believe that simply increasing the tax credit for individual contributions will effectively decrease PAC money or PAC influence in Congress. Second, a 100-percent tax credit without effective bundling restrictions will in fact become a potent new tool for increasing the power of PAC's, and we do not think the House provision has an effective——

Senator **Chafee**. Could you define "bundling?"

Mr. **Wertheimer**. Yes; I am going to. Bundling is a practice whereby PAC's will ask their members to write out checks individually to candidates, collect that money, and turn it over to the candidate. It is a way of getting around the $5,000 limit on what PAC's can give to a candidate. In our view, it is an evasion of the PAC limit. The FEC has presently held that it should not be counted against the PAC limit, and the impact of that is to allow PAC's to, in effect, provide very substantial sums of money in the form of individual contributions. We think that is wrong and that the law should be changed. We also think that if you have that kind of system and allow PAC's to, in effect, collect and channel "free" money—100 percent tax credit money—they are the ones best positioned to organize and raise that money, and you are going to increase their role in the congressional process, not decrease it.

The third point I would like to make is that the 100-percent tax credit by itself available annually will provide an undue advantage for incumbents over challengers. Incumbents already have a major edge in raising small contributions by a margin of about 2½ to 1. The 100-percent tax credit will multiply that advantage, and the reason is the following. It is drafted in a way that the 100-percent tax credit is available to be raised annually. It means that incumbents will be raising this money in off-years. In the case of the Senate, it would be raised over a 6-year period while challengers will be raising it for the most 1 or 2 years. So, you are really providing a public subsidy in a way that represents an uneven playing field, and it is by itself and available annually, simply unfair to challengers.

We have supported the 100-percent tax credit as part of a comprehensive package of reforms. We think it could play a valuable role in a larger reform package in a way that would provide incentives for small contributions without benefiting incumbents at the expense of challengers contain strictly anti-bundling provisions and without becoming a vehicle for PAC's to maximize their influence.

In the case of the dollar tax check-off, we have as you know strongly supported the Presidential public financing system. The administration's proposal to repeal the dollar tax check-off is not tax reform. It does not deal with a tax preference. There is no alternative way proposed for funding the Presidential public financing system. The net result of it will be to kill Presidential public financing. We think that would be a disastrous mistake and a step backwards.

So, in conclusion, I would again want to say with respect to the 100-percent tax credit, by itself, we think it is not a solution. It could very well, and as drafted will, exacerbate the campaign finance problem in Congress; and it is unfair in the way it would be implemented on behalf of incumbents versus challengers. We therefore urge this committee not to support the 100-percent tax credit that passed the House.

Senator CHAFEE. All right. Fine. Thank you very much.

Mr. Ruhm.

[The prepared written statement of Mr. Wertheimer follows:]

TESTIMONY OF FRED WERTHEIMER
PRESIDENT
COMMON CAUSE

ON H.R. 3838
THE TAX REFORM ACT OF 1985

BEFORE THE COMMITTEE ON FINANCE
U.S. SENATE

FEBRUARY 4, 1986

Summary

o Standing by itself, in the form passed by the House, the 100% tax credit for political contributions is basically flawed and should not be enacted. It will not stop the driving influence of PACs on Congress which is the single biggest problem in the current congressional campaign finance system. Without effective "anti-bundling" language, the 100% tax credit will, in fact, provide PACs with a potent new tool for increasing their influence and will seriously undermine current contribution limits for PACs. PACs are presently best situated to organize and channel "free" contributions to congressional candidates.

o The House-passed tax credit gives an unfair advantage to incumbents. The major edge incumbents already have today in raising small contributions will be multiplied by "no cost" contributions without other campaign finance reforms to accompany it. A 100% tax credit available annually and by itself provides public assistance for incumbents in nonelection years when challengers have not even announced. In the Senate, for example, an incumbent could raise $600 per person ($1200 per couple) in publicly subsidized contributions over a six year term, compared to $100 or $200 per person ($200 or $400 per couple) for a challenger who is unlikely to be a candidate until election year or the year before.

o Common Cause has supported a comprehensive campaign finance reform package including limits on PAC contributions; "anti-bundling" language to close the loophole which permits PACs to serve as a conduit for individual contributions and thereby evade current PAC contribution limits; 100% tax credits for political contributions; overall spending limits; limits on the use of personal wealth; and response time for candidates who are the subject of broadcast independent expenditure campaigns. In the context of a package of reforms, the 100% tax credit can play a valuable role in providing incentives for small contributions without benefiting incumbents at the expense of challengers, or serving as a vehicle for PACs to maximize their influence.

o We urge the Committee to join the House in rejecting the Administration's proposal to repeal the dollar tax check-off used to finance presidential elections. Repeal of the check-off is not tax reform; the check-off is not a loophole or preference.

o The White House has not proposed an alternative source of financing for presidential elections and has indicated it would probably oppose any direct appropriation for this purpose. Repeal of the check-off is a back-door maneuver to kill public financing for presidential elections.

o Public financing for presidential elections has worked and should be retained. It has reduced the influence of large contributors and PACs. Repeal of the check-off is an open invitation to return to the presidential campaign finance abuses of the Watergate era.

Thank you, Mr. Chairman and Members of the Committee, for this opportunity to testify on the 100% tax credit for political contributions, which is part of the House-passed tax reform bill. The issue of campaign finance reform has been of central concern to Common Cause throughout its fifteen-year history, and I am pleased to present our views for this Committee's consideration.

Mr. Chairman, the current congressional campaign finance system is out of control and in need of fundamental reform. The biggest problem with the current system is the increasingly dominant role played by PACs, their negative influence on our system of elections and, most importantly, their negative influence on congressional decision-making. There is a growing national consensus that the PAC system is undermining our representative form of government and must be changed.

As the Congress seeks to address the problems of the current campaign finance system a basic test must be applied: Will the solution effectively help solve the PAC problem?

We believe, Mr. Chairman, that the 100% tax credit alone, as passed by the House, fails this test. It will not stop the driving influence of PACs. In fact, as we will discuss, it could make the problem worse.

Common Cause has supported a comprehensive campaign finance reform package aimed at limiting PAC contributions, encouraging greater reliance on small contributions through the use of 100% tax credits, providing some form of alternative financing for congressional elections, limiting the use of personal wealth, providing overall spending limits, and controlling the problem of independent expenditures. For example, in 1983, Common Cause supported legislation in the House which combined the 100% tax credit with aggregate PAC limits, overall spending limits and other key features, and which garnered 150 co-sponsors.

Standing by itself, however, we believe the 100% tax credit is a flawed proposal, one which would not solve the growing PAC problem and could open up new loopholes in current campaign finance laws that would increase, rather than decrease, the already dangerous influence of PACs. It is clear that PACs are in the best position to organize and channel the new funds that would flow into campaign coffers were the proposal enacted into law without further restrictions.

The 100% Tax Credit for Political Contributions

Current law provides a 50% tax credit for political contributions to candidates for federal, state, or local elective office, to political parties, and to political action committees. The tax reform bill pending before the House Ways and Means Committee last fall proposed to repeal the 50% tax credit. An effort was made late in the Committee's mark-up of the bill to replace the current tax credit with a new, 100% tax credit for in-state political contributions to congressional candidates.

That amendment was defeated by the Ways and Means Committee by a 14 to 21 vote.

Despite the Committee's rejection of the 100% tax credit amendment, supporters were successful in a last-minute effort to make the amendment in order when the tax bill was considered on the House floor. The amendment was adopted by the full House after a short debate of less than 30 minutes, by a vote of 230 to 196.

Common Cause opposed the 100% tax credit amendment during House consideration and strongly urges the Finance Committee not to allow the tax credit to be enacted into law by itself. We oppose the 100% tax credit alone for the following reasons.

First, the 100% tax credit proposal contained in the House-passed tax bill is not the remedy to the PAC problem. Despite claims by some proponents, there is no realistic reason to believe that simply increasing the tax credit for individual contributions will decrease PAC money or influence in congressional campaigns. PACs will still have every incentive to give; candidates will continue to have every incentive to accept. The ten-year track record of exponential growth in PAC giving and PAC influence will continue, with PAC funds continuing to be focused on incumbent Members of Congress.

Second, a 100% tax credit without effective bundling restrictions will serve to exacerbate the role and influence that PACs exert today. Bundling is a practice whereby PACs solicit and then bundle together political contributions made by their members to individual candidates, with the PAC serving as the conduit for delivering those bundled contributions. This practice permits PACs to avoid the limits on PAC contributions which would otherwise apply.

A 100% tax credit without effective bundling restrictions will become a potent tool for increasing the influence of PACs. PACs are best situated to organize tax-subsidized contributions from their already known givers. If they are free to help raise and channel these funds, their ability to influence and dominate Congress will escalate, not decrease. Instead of providing $5,000 or $10,000 to a candidate, they will provide $50,000 or $100,000.

Bundling is already a serious problem under current law, a problem which threatens to seriously undermine current limits on PAC contribution limits. A recent Common Cause survey revealed that at least six of the nation's top twelve defense contractors "bundle" contributions to candidates. Bundling has also been used heavily by the insurance industry, which has an important stake in the tax bill before this committee.

In response to concerns raised by Common Cause and others, the tax credit amendment offered on the House floor was modified from the original version offered in Committee in an effort to address the bundling issue. However, the bundling language contained in the House-passed amendment, which makes taxpayers ineligible for the credit if their contribution is subsequently bundled, is inadequate to deal with the bundling problem.

Bundling can be controlled, however. The most effective means for enforcing anti-bundling restrictions is to require PACs themselves to count bundled contributions against the PAC contribution limits established in current law. Such language is contained in the campaign finance amendment authored by Senator Boren, which the Senate refused to table in a vote on December 3, 1985. Common Cause strongly supports the Boren amendment and believes its approach to bundling is a realistic way to curb bundling abuses.

Third, the House-passed 100% tax credit would provide an undue advantage to incumbents compared to challengers. The congressional campaign finance system is already biased in favor of incumbent office-holders. Under current law, incumbents are the biggest beneficiaries of PAC contributions, by a margin of almost 4 to 1. Incumbents also have a major edge today in raising small contributions, by a margin of 2½ to 1, an advantage that will be multiplied by the 100% tax credit passed in the House.

A 100% tax credit available annually will be used by incumbents to conduct off-year fundraising at a time when challengers have not even announced. Because of the six-year term in the Senate, an incumbent would have access to $600 per term per person (and $1200 per term per couple) in "free" contributions, compared to $100 or $200 ($200 or $400 per couple) for a challenger who won't be running until the election year or the year before at the very earliest.

Thus, the 100% tax credit available annually and standing by itself will further increase the competitive advantage which incumbents hold today over challengers. On the other hand, if the 100% tax credit is part of a larger package of campaign finance reforms, including an aggregate limit on PAC contributions, these effects can be counterbalanced. (An aggregate PAC limit would, of course, have a greater impact on incumbents.)

In summary, the 100% tax credit standing alone is basically flawed. The notion that the tax credit by itself can dilute the impact of the PACs is wrong. It will not stop the driving influence of PACs, which is the most serious problem in our current campaign finance system. Indeed, without effective anti-bundling provisions, the 100% tax credit will provide PACs with a potent new tool for increasing their dominance in the legislative and political process and threatens to seriously undermine current limits on PAC contributions.

On the other hand, the 100% tax credit can appropriately be included as part of a larger package. Common Cause supports a series of changes in the campaign finance laws to address the escalating problem of PACs. An aggregate PAC limit is absolutely essential to stopping the growth and impact of PAC contributions on Congress and decreasing the dependence of Members of Congress on PACs.

Dollar Tax Check-Off for Presidential Campaigns

Mr. Chairman, while the major focus of my testimony has been on the 100% tax credit for political contributions, I would like to comment briefly on the critical importance of retaining the dollar tax check-off used to finance presidential election campaigns.

The tax reform plan outlined last year by President Reagan eliminates the dollar tax check-off -- the mechanism on federal income tax forms which allows taxpayers to designate one dollar of their tax liabilities to be used for public financing of presidential campaigns. The House rejected this proposal and instead, chose to retain the dollar tax check-off. Common Cause strongly urges this Committee to do the same.

President Reagan's proposal to repeal the dollar tax check-off is not tax reform and does not fit within the general approach to tax reform announced by the Administration. As the Administration itself has conceded, "the check-off does not directly affect individual tax liabilities." The check-off is not a tax loophole or preference. It is not a device for lowering any individual's taxes. Rather, the check-off is a provision for directing to a particular program -- the public financing of presidential elections -- taxes which are already owed to the government.

The Administration claims it favors elimination of the check-off because it "is a source of confusion" to the taxpayers. Yet the Administration does not propose an alternative source of financing for presidential elections, and a White House spokesman has indicated that the President would probably oppose any congressional appropriation for the fund.

The net result of the Administration's proposal to repeal the dollar tax check-off therefore would be to kill the presidential public financing system. The Washington Post, in an editorial in support of the tax check-off, noted:

> The official answer is that the check-off was eliminated in the Reagan plan because it takes a line on the tax return and has confused some taxpayers; you see, we just wanted to simplify things. Sure. Intentionally or not, the scrapping of the check-off makes a major change for the worse in a campaign finance law that has worked tolerably well. This isn't a tax issue at all. Whatever Congress does with the president's bill, it should keep the check-off as it is.

The fight to retain the dollar tax check-off is really a fight to preserve the presidential public financing system. Simply stated, that system is an idea that works -- it is the crowning achievement of the amendments adopted in 1974 to the

Federal Election Campaign Act. Under the system, candidates who agree to abide by limits on overall campaign spending and the expenditures of personal wealth are able to receive federal tax dollars -- funds designated to a separate account by individual taxpayers. Public funds are available to match small private contributions raised by candidates during the nominating process; for the general election, major party candidates are entitled to full campaign funding with public dollars.

In the three elections for which this new system has been in place -- 1976, 1980, and 1984 -- presidential public financing has been successful. The presidential public financing system was recently reviewed by the Commission on National Elections, headed by Robert Strauss and Melvin Laird. The Commission concluded:

> Public financing of presidential elections has clearly proved its worth in opening up the process, reducing undue influence on individuals and groups, and virtually ending corruption in presidential election finance. This major reform of the 1970's should be continued.

Since the law was passed, thirty-four of thirty-five party candidates have chosen to participate in this voluntary system. President Reagan himself has received over $90 million in public funds for his 1976, 1980, and 1984 presidential campaigns.

Presidential public financing has checked the increase in presidential campaign expenditures. Presidential contenders no longer must "tin-cup" it around the country in search of campaign funds. In contrast to the presidential contest of 1972, candidates are no longer dependent on a relatively few "fat cat" contributors -- the funding base for campaigns is broad. Political action committees play a relatively minor role in financing presidential candidates -- PACs gave less than $1.5 million to 1984 presidential candidates, or less than two percent of total funds raised.

Reliance on special interest groups for their political funds has been replaced by a new source of campaign funds -- public dollars designated to a special account by individual taxpayers. As the New York Times observed in an editorial opposing the Administration's attempt to repeal the dollar tax check-off, "Public financing confers on presidential candidates the freedom not to grovel." Public financing has also conferred the added freedom to govern -- without the strings attached by large contributors or public suspicion that such strings exist.

The public financing system for presidential elections has worked well. Repeal of the dollar tax check-off is a back-door approach to killing this system and is an open invitation to return to the presidential campaign financing abuses of the past. We strongly urge this Committee to oppose efforts to repeal the dollar tax check-off.

Thank you for this opportunity to testify.

STATEMENT OF THOMAS F. RUHM, VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL, BESSEMER SECURITIES CORP., NEW YORK, NY

Mr. RUHM. Thank you, Mr. Chairman, members of the public. It is a great pleasure to be here to testify before this committee. I am here on behalf of my company, Bessemer Securities Corp. in New York and all corporate investment companies similarly situated. I am here to urge that corporate capital gains should be taxed at the same rate as individual's capital gains and that both should have a 50-percent exclusion from taxation. Furthermore, capital gains must be removed as a preference item from the corporate add-on minimum tax in order that that differential not be reduced.

The capital gains differential is a proven incentive to long-term investment. Today, as of the end of last year 1984, we have over $16 billion committed to venture capital investing, for instance, versus $4 billion in 1978, which had remained a static figure at that level since 1969. In the 7 years since 1978, we have had a booming market for underwritten public offerings of equity securities for companies of all sizes. Furthermore, we had the country up and moving in 1979 and 1980 on the strength of the 1978 capital gains tax cuts alone, even before the Economic Recovery Tax Act of 1981.

Now, H.R. 3838 is going to drastically lower the capital gains differential for individuals, 60 to 42 percent; and it is going to eliminate it for corporations, 40 percent to zero. Corporations are just as good long-term equity investors as individuals and partnerships are. Nearly 90 percent of the National Association of Small Business Investment Companies are corporations. Of the $16 billion committed to venture capital at the end of 1984, over 40 percent, or nearly $7 billion, came from corporations. Those funds are the Nation's seed corn for starting and growing new businesses. Now, $7 billion may not sound like much in Government circles, but it is still a big number in private circles; and $7 billion as seed corn goes a long, long way. Over 1,000 successful new businesses can be started with that kind of money; and that is a lot of technological development. At the same time, small businesses throughout the country make the greatest contribution to employment.

If you continue to tax corporations' capital gains at rates higher than the rates applied to individuals, corporations will gradually phase out of long-term equity investment. My company has been making venture capital and other long-term equity investments for over 70 years. Historically, we have invested in Ingersoll-Rand, International Paper, Texaco, W.R. Grace, all on a venture capital basis. Today, we boast no less than 15 publicly traded companies that we have sponsored and several more that have become divisions of major companies.

We cannot change to a limited partnership for fear of dispersing the concentration of assets that has produced these investment successes. The taxes involved in liquidation alone would take away much of our strength.

Finally, there would be a dynamic revenue gain from reducing the capital gains tax rate on long-term equity investments by corporations. The experience with revenue gains from capital gains taxes on individuals after the substantial rate reduction in 1978 from $9.3 billion revenue in 1978 to $12.9 billion in 1982, the only years it is available so far, would definitely be repeated in the case of corporations at least as far as long-term equity investments are concerned.

Therefore, I reiterate: Reduce the corporate capital gains rate to the level of the individual rate in all regards. Thank you.

Senator **Chafee**. Thank you.

[The prepared written statement of Mr. Ruhm follows:]

STATEMENT OF THOMAS F. RUHM, VICE PRESIDENT AND ASSISTANT GENERAL COUNSEL OF BESSEMER SECURITIES CORPORATION, NEW YORK, NEW YORK, AT THE HEARING OF THE SENATE COMMITTEE ON FINANCE ON THE TAX REFORM ACT OF 1986 ON FEBRUARY 4, 1986

SUMMARY

1. The capital gains differential has had an undeniably beneficial effect upon long-term equity investment in this country.

2. H.R. 3838 maintains a substantial capital gains differential for long-term investments by individuals, but inexplicably eliminates the differential for corporations.

3. Making the long-term capital gains tax rate substantially lower than the tax rate on ordinary income has the same beneficial effect upon long-term investments by corporations that it does upon long-term investments by individuals.

4. If corporations' capital gains are taxed at 36% (H.R. 3838) and their income from other sources is taxed at 36%, high-yielding bonds will look like much better investments to them than equity growth situations.

5. Corporations are still a substantial factor in the venture capital investing process, providing more than 40% of the capital dedicated to venture capital investing as of the end of 1984, but that percentage has declined from 55% at the end of 1981.

6. A lower corporate capital gains tax rate would play an important role in encouraging corporations to finance innovation, new ideas and the growth sectors of our economy, thus creating new jobs and broadening the tax base.

7. The Tax Reform Act of 1986 should "reform" the corporate capital gains rate, from the 36% proposed by H.R. 3838, and the 28% provided by existing legislation, to whatever the maximum individual capital gains tax rate is.

8. In 1978 the untaxed portion of long-term capital gains was removed as a tax preference item for individuals, but was not so removed for corporations through legislative oversight. It should be so removed in the Tax Reform Act of 1986.

THE CORPORATE CAPITAL GAINS DIFFERENTIAL SHOULD BE FULLY RESTORED

The capital gains differential has had an undeniably beneficial effect upon long-term equity investment in this country. The record since 1978 is crystal clear that growth is stimulated by lower capital gains tax rates.

H.R. 3838 continues this policy for capital gains realized by individuals -- although it has substantially diminished the differential for individuals from 60% to 42%. However, for corporations H.R. 3838 has inexplicably eliminated the differential altogether: Both capital gains and ordinary corporate income are to be taxed at 36%!

The Economic Recovery Tax Act of 1981 cut the maximum individual capital gains tax rate from 28 percent to 20 percent. This change substantially reduced the tax burden on individual saving and investment and stimulated greater capital formation, lasting economic growth and job creation. H.R. 3838, the pending tax reform legislation, would set the maximum individual capital gains tax rate at 22%.

Unfortunately, the 1981 Act did not reduce the corporate capital gains tax rate from the 28 percent rate set in 1978 and left a difference of eight percentage points between the corporate and individual rates. Now H.R. 3838 would increase the corporate capital gains rate to 36% and increase the difference to fourteen percentage points.

From its enactment in 1942 until 1969, the maximum corporate capital gains tax rate was a flat 25 percent or 26 percent, exactly equal to the top rate for individuals. In 1969, the corporate rate began phasing up to 30 percent in tandem with the substantial increases in individual capital gain tax rates.

Nine years later, when Congress reduced capital gains tax rates through the Revenue Act of 1978, the top individual capital gains tax rate was cut to 28 percent, and, at the same time, the corporate capital gains rate was reduced to 28 percent. However, at that time while the untaxed portion of long-term capital gains was eliminated as a tax preference item for individuals, it was not so eliminated for corporations. This was an oversight, and it left corporations paying a 29.67% rate on long-term capital gains. Nevertheless, the rates were otherwise substantially in parity.

The 1981 Act, however, having reduced individual but not corporate capital gains tax rates, and again having failed to eliminate the untaxed portion of long-term capital gains as a tax preference item for corporations, created a substantial imbalance in the tax treatment of capital gains between individuals and corporations. This will become a whopping imbalance under H.R. 3838.

This lack of equality under the tax law between individual and corporate capital gains tax rates has caused economic distortions and will, if not eliminated, cause even greater economic distortions, in a number of areas such as venture capital investment. Corporate venture capitalists are at a disadvantage in dealing with entrepreneurs as opposed to individual venture capitalists because their tax costs are substantially higher.

According to estimates as of the end of 1984 (more recent data is not available), the professional venture capital industry currently manages approximately $16.3 billion in assets. Of that $16.3 billion, more than 40 percent is organized and managed in corporate form (That figure was 55% at the end of 1981).

At the present time industrial corporations, using internal corporate capital as opposed to pension fund capital, are the second leading source of capital for venture capital investments (see Exhibit A). In addition, as of the end of 1984 corporations had committed 23% of the total funds raised for private independent venture capital firms.

The total amount committed at that time by corporations to venture capital investing -- $6.7 billion -- may seem trivial by Government standards. But $6.7 billion is still a big number in the private sector, and, more importantly, it represents a substantial portion of our nation's "seed corn" for starting and growing new businesses. As "seed corn" $6.7 billion goes a long way.

New technological breakthroughs are critical to the productivity increases needed by the American economy. A lower corporate capital gains tax rate would play an important role in encouraging corporations to finance innovation, new ideas and the growth sectors of our economy and, thus, creating new jobs and broadening the tax base -- an objective shared by both the Congress and the Administration.

The significant difference between the individual capital gains tax rate and the corporate capital gains rate has caused increasing pressures on venture capitalists and other long-term equity investors to organize their activities into individual or partnership form. It has encouraged investors to skew the form of their business entities solely for tax reasons and not for economic considerations.

Still again, some, for various and valid reasons, have been unable to switch to partnership form and so have been, and are being, prompted to move their assets out of long-term equity investments into higher yield situations. Corporations may deduct from taxable income up to 85% (80% and diminishing further by 1% per year for ten years, to 70%, under H.R. 3838) of the amount of dividends received on common or preferred stock. It makes no sense to reduce investible funds available for growth. In view of the foregoing, the historic parity between corporate and individual capital gains tax rates should be restored at the first opportunity.

Two simple technical adjustments to maintain corporate and individual rate parity are set forth on Exhibit B. These adjustments eliminate the untaxed portion of long-term capital gains from the definition of tax preference income for the purposes of the add-on minimum tax for corporations and set the flat corporate capital gains rate at the maximum individual capital gains rate, thereby preventing economic distortions. If only the rate-change adjustment were made, the effective corporate capital gains tax rate would still be a too high 25.48%.

Corporations are just as good a source of long-term investment capital as any other. But they too need incentives to take the substantial risks that long-term investment entails. If their capital gains are taxed at 36% and their income from other sources is taxed at 36%, high-yielding bonds are going to look like much better investments to them than venture capital situations. Why take this capital out of the pool of risk capital that is available for the long-term equity investments that are so vital for the fundamental growth of this country?

Thomas F. Ruhm

VENTURE
ECONOMICS

EXHIBIT A

June 3, 1985

Mr. Paul Bancroft III
Bessemer Venture Partners
630 Fifth Avenue
New York, New York 10111

Dear Pete:

You have requested that I update the data which shows that a significant part of the venture capital industry is taxed at corporate tax rates. This is an important, but often overlooked, consideration in capital gains tax planning. The following information shows that corporations should receive the same reductions that individuals have received in maximium capital gains tax rates since 1978.

As of December 31, 1984, the organized venture capital industry had total committed capital of approximately $16.3 billion (not adjusted for current market value of investments), this country's dedicated pool of capital investment for new business development. Of this, $11.8 billion was held by independent private firms, $1.6 billion by small business investment companies (SBICs) and $2.9 billion by corporate subsidiaries. The latter two categories are virtually entirely corporate investors, so we could safely say that at least $4.3 billion of their total of $4.5 billion was represented by corporations. Although it is difficult to predict the effect from year to year, some of the SBICs are regustered investment companies which may pass through their capital gains to their stockholders for tax purposes. In any event, this would involve less than $300 million of these assets, leaving at least $4 billion in these categories.

The independent private firms consist primarily of partnerships, some of whose limited partners are corporations as well as corporate form vehicles. Our records indicate that corporate investors have provided $1.4 billion and insurance companies $1.3 billion of the $11.8 billion. The balance comes from pension, endowment, individual, and foreign investors.

If we total the $4 billion from the corporate segments of our industry plus the $2.7 billion from the above corporate investors, we see that approximately $6.7 billion of the $16.3 billion is subject to capital gains taxation at corporate tax rates. Since this represents approximately 41% of the industry, this is a very significant factor for consideration in the planning of the effect of capital gains taxation.

I hope this information is helpful. Please contact me if you have any questions.

Very truly yours,

Stanley E. Pratt
Chairman

SEP:lg

cc: William R. Thomas

Venture Economics, Inc.
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EXHIBIT B

Conforming Changes in the Corporate Alternative Capital Gains Tax

Sec. [1]. REDUCTION OF ALTERNATIVE CAPITAL GAINS FOR CORPORATIONS.

(a) GENERAL RULE.--Paragraph (2) of section 1201(a) (relating to alternative tax for corporations) is amended by striking out "28 percent" and inserting in lieu thereof "the maximum effective capital gains tax rate for noncorporate taxpayers computed under section 1202 and Section 1."

(b) TRANSITIONAL RULE.--

A transitional rule along the lines of section 1201 (c) would be included.

Conforming amendments would be made to sections 58(g) (2), 170 (e) (1) (B), 593 (b) (2) (E), 852 (b) (3) (D) (iii).

Sec. [2]. ELIMINATION OF THE UNTAXED PORTION OF CAPITAL GAINS AS A TAX PREFERENCE ITEM FOR CORPORATIONS

Delete section 57(a)(9)(B) in its entirety and make conforming numbering changes in related subsections.

Senator **Chafee**. Aren't you going farther than that? As I understood your testimony, if you take the maximum corporate rate at 33 percent, you said it should be at—the maximum capital gains rate—50 percent of that. Isn't that what you said?

Mr. **Ruhm**. No; I said the exclusion should be 50 percent, Mr. Chairman. And if you leave the individual rate at 22 or reduce it to 20, what I am asking is that whatever exclusionary percentage gets to that, be applied to corporate capital gains. I would like to see it at 50 percent. I think that is a good historical figure. It has worked very well for this country in the past.

Senator **Chafee**. Wouldn't that get the capital gains down to 16.5?

Mr. **Ruhm**. Or 17.5, no, you are right, 16.5. Whatever the top rate for ordinary income is divided by two. The absolute rate is not important here; it is the differential——

Senator **Chafee**. The differential, yes.

Mr. **Ruhm**. That is why I talk in terms of that. I can understand the political aspects of it, though.

Senator **Chafee**. Where does it stand now? If the individual is 20 percent, what is the corporate now for capital gains?

Mr. **Ruhm**. In H.R. 3838, or the present law?

Senator **Chafee**. No, no, the present law.

Mr. **Ruhm**. Twenty-eight percent for corporations.

Senator **Chafee**. Twenty-eight percent. That is what I thought.

Mr. **Ruhm**. Versus the 46 percent ordinary rate for corporations.

Senator **Chafee**. But you still have your differential?

Mr. **Ruhm**. There, we do. We have a 40-percent differential. It is not as good as we would like, but——

Senator **Chafee**. Twenty? You have the difference between 20 and—what did you say?

Mr. **Ruhm**. Twenty-eight and forty-six. That is right.

Senator **Chafee**. Let's stick to the capital gains.

Mr. **Ruhm**. Well, that is where you measure the differential between the ordinary rate and the capital gains rate.

Senator **Chafee**. Yes. The difference between the corporate capital gains rate and the individual capital gains rate

Mr. **Ruhm**. Yes. That is the problem, or one of the problems.

Senator **Chafee**. The difference now between 20 and 28 percent. Right?

Mr. **Ruhm**. On that issue, yes, sir.

Senator **Chafee**. And that is a difference of how much?

Mr. **Ruhm**. Eight percent.

Senator **Chafee**. Well, it is more than 8 percent.

Mr. **Ruhm**. Well, yes, because you have the add-on minimum so in effect it is about 29.5 versus 20.

Senator **Chafee**. And yet life is going on with that differential?

Mr. **Ruhm**. It is not going on as well as it should be. Corporations contributed 55 percent of the capital committed to venture capital in 1981; now it is down to 40. It will go down further.

Senator **Chafee**. In your testimony, you talk about $16 billion of venture capital, of which 40 percent came from corporations. Were those corporations—you may not know the answer to this—but were those corporations taxable entities?

Mr. **Ruhm**. Yes.

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Senator **Chafee**. In most instances?

Mr. **Ruhm**. Yes. That is not including foreign corporations, for instance.

Senator **Chafee**. Yes. I was thinking of pension plans.

Mr. **Ruhm**. Not including pension funds.

Senator **Chafee**. And insurance and so forth?

Mr. **Ruhm**. No, pension funds is a separate category.

Senator **Chafee**. I see. All right. Mr. Wertheimer, I think the points you make make a lot of sense. Of course, you were here when Congressman Frenzel was testifying.

Mr. **Wertheimer**. Yes, Senator.

Senator **Chafee**. I think what the House did is bad business. I don't believe in 100 percent tax credits on donations.

Mr. **Wertheimer**. Sure.

Senator **Chafee**. I think there ought to be some actual contribution in there.

Mr. **Wertheimer**. Yes.

Senator **Chafee**. Thank you very much.

Mr. **Wertheimer**. Mr. Chairman, could I just ask one thing?

Senator **Chafee**. Yes, go ahead.

Mr. **Wertheimer**. We submitted a full statement, and I would like that to be part of the record.

Senator **Chafee**. Oh, yes. We will do that.

Mr. **Wertheimer**. Thank you.

Mr. **Ruhm**. As would I, Mr. Chairman.

Senator **Chafee**. Fine.

Mr. **Ruhm**. Thank you, Mr. Chairman.

Senator **Chafee**. Thank you very much. That concludes it.

[Whereupon, at 12:25 p.m., the hearing was adjourned.]

[By direction of the chairman the following communications were made a part of the hearing record:]

STATEMENT OF SENATOR ROBERT W. KASTEN, JR.
EFFECTIVE DATE OF TAX REFORM
FEBRUARY 26, 1986

Mr. Chairman: Today I am introducing legislation to help clarify the many questions about effective date of any changes in the tax code.

The House of Representatives has adopted a tax bill which sets January 1, 1986 as the effective date of changes in the tax code. This has created a climate of uncertainty and confusion that is paralyzing many critical business and public sector decisions.

It is unclear to anyone how the decisions that they are making today will be treated for tax purposes.

The result is a "Twilight Zone of Taxes." In this "Twilight Zone" no one can predict what will be the tax effect of their actions.

The legislation I am introducing today will remedy this problem by setting a precise date in the future for any changes in the tax code. This legislation provides that no changes in the tax code initiated as a part of current tax reform legislation will become effective until January 1, 1987.

It is totally unacceptable to require taxpayers to accept a retroactive date for new tax provisions as provided in the House bill.

This condition is blocking critical decisions that would provide more jobs and important services across the nation. In effect, the effective date issue precipitated by the House legislation is putting the breaks on the current economic expansion.

Around my state municipalities and private industry have withheld initiating important building and capitol improvement projects. These same problems are occurring around the nation.

Mr. Chairman, I call on all of my colleagues who are interested in steering our nation to continued economic expansion and out of the "Twilight Zone of Taxes." I hope they will join me in supporting this legislation to set a certain date for any changes in the tax code.

Mr. Chairman, I ask unanimous consent that the text of this legislation be printed at this point in the record.

* * *

STATEMENT OF THE HONORABLE GUY A. VANDER JAGT (R.-MICH.)

Before the Senate Committee on Finance
of the United States Senate
February 4, 1986
on
H.R. 3838

Mr. Chairman and Members of the Committee, you have my deepest sympathies given the task before you, the consideration of comprehensive tax reform legislation presented by President Reagan and now passed by the House of Representatives in the form of H.R. 3838. It is a difficult task for many reasons; political, economic, and technical. In addition, and quite importantly, the President has indicated that he has several fundamental problems with the current form of H.R. 3838; specifically, concerning capital formation, the $2000 personal exemption, effective dates, etc. My intent in submitting this statement for your consideration is not to recite how tough the task is before you; rather my intent is to help you with that task by directing your attention to the REPUBLICAN ALTERNATIVE to H.R. 3838 developed and endorsed on an almost unanimous basis by both the Republican Members of the Ways and Means Committee and

Republican Leadership of the House of Representatives. The key differences between the REPUBLICAN ALTERNATIVE and H.R. 3838 are discussed below followed by a detailed description. The statutory language is contained in H.R. 3879. On almost every significant count, I believe the REPUBLICAN ALTERNATIVE is a superior product to H.R. 3838, representing a more balanced, thoughtful approach to tax reform while taking account of the inherent risks in such a major change to our existing tax system from the standpoint of our economy in general and in particular with respect to its potential impact on specific critical industries.

With that overall approach in mind, the REPUBLICAN ALTERNATIVE reverses the anti-family, anti-savings, anti-foreign competitiveness, anti-capital formation, anti-private retirement system direction of H.R. 3838 through a number of essential improvements while maintaining the four most critical elements of the President's Proposal:

- o Revenue Neutrality
- o Significant Overall Rate Reduction
- o Protection of Home Mortgage Interest Deduction
- o Dramatic Tax Relief for Lower Income Taxpayers

PRO FAMILY: H.R. 3838 HAS AN ANTI-FAMILY BIAS BECAUSE IT REDUCES A TAXPAYER'S ITEMIZED DEDUCTIONS IN RELATION TO THE NUMBER OF A TAXPAYER'S CHILDREN. FOR EXAMPLE, IF A TAXPAYER HAS 3 DEPENDENTS, HIS OR HER ITEMIZED DEDUCTIONS ARE REDUCED BY $1,500; 5 DEPENDENTS -- REDUCED BY $2,500; 7 DEPENDENTS (I.E., A FAMILY OF 5 CHILDREN) -- REDUCED BY $3,500. THE REPUBLICAN ALTERNATIVE REVERSES THIS ANTI-FAMILY BIAS BY PROVIDING A $2,000 PERSONAL EXEMPTION PER DEPENDENT WHILE IMPOSING NO REDUCTION IN ITEMIZED DEDUCTION WHICH IS RELATED TO THE NUMBER OF CHILDREN OF A TAXPAYER. THE REPUBLICAN ALTERNATIVE PROVIDES A FULL $2,000 PERSONAL EXEMPTION FOR ALL TAXPAYERS IN THE FIRST TWO RATE BRACKETS -- APPROXIMATELY 90 PERCENT OF ALL TAXPAYERS -- WITH A DIMINISHED PERSONAL EXEMPTION FOR HIGHER INCOME, HIGH MARGINAL RATE TAXPAYERS. THE COMBINED AFFECT OF THE DIFFERENCES BETWEEN H.R. 3838 AND THE REPUBLICAN ALTERNATIVE AS IT IMPACTS ON LOW AND MIDDLE INCOME FAMILIES IS JUST SHORT OF REMARKABLE. ANALYSES PREPARED BY TWO NATIONAL ACCOUNTING FIRMS CONFIRM THAT THE REPUBLICAN ALTERNATIVE PROVIDES HIGHER ITEMIZED DEDUCTIONS AND LOWER TAXABLE INCOME TO ALMOST ALL FAMILIES UNDER $75,000 OF GROSS INCOME THAN DOES H.R. 3838 WHILE H.R. 3838 PROVIDES HIGHER ITEMIZED DEDUCTIONS AND LOWER TAXABLE INCOME FOR FAMILIES WITH OVER $75,000 OF INCOME. SEE ANALYSES ATTACHED.

PRO MARGINAL RATE REDUCTION -- IMMEDIATELY -- FOR INDIVIDUALS: H.R. 3838 PROVIDES MARGINAL RATE REDUCTIONS FOR INDIVIDUALS WHICH PHASE-IN OVER TWO YEARS TO REDUCE THE TOP INDIVIDUAL MARGINAL RATE TO 38%. GIVEN THE PROPENSITY OF CERTAIN ELEMENTS OF THE CONGRESS FOR TRYING TO RAISE REVENUE BY PREVENTING TAX CHANGES FROM FULLY PHASING INTO EFFECT, INDIVIDUAL TAXPAYERS AND THE PRESIDENT SHOULD BE EXTREMELY WARY OF PHASED-IN INDIVIDUAL RATE REDUCTIONS. ONLY A SHORT TIME AGO THERE WERE ATTEMPTS TO PREVENT THE THIRD YEAR OF PRESIDENT REAGAN'S 1981 THREE-YEAR RATE REDUCTION AND THE INDEXING OF TAX RATES FROM GOING INTO EFFECT. THE REPUBLICAN ALTERNATIVE, RECOGNIZING THIS "FREEZE" FACTOR, PROVIDES A REDUCTION OF THE TOP MARGINAL RATE TO 37 PERCENT EFFECTIVE IMMEDIATELY, ON JANUARY 1, 1986. AS A RESULT, THE REPUBLICAN ALTERNATIVE PROVIDES MORE GENEROUS AVERAGE TAX REDUCTIONS TO ALL INCOME GROUPS THAN DOES H.R. 3838. SEE THE COMPARISON OF THE DISTRIBUTIONAL IMPACT OF THE REPUBLICAN ALTERNATIVE WITH H.R. 3838 ATTACHED.

PRO SAVINGS: H.R. 3838 HAS AN ANTI-SAVINGS, PRO-CONSUMPTION BIAS WHICH IS INCOMPREHENSIBLE FROM A NATIONAL ECONOMIC POLICY PERSPECTIVE CONSIDERING THE FACT THAT AMERICANS ARE CURRENTLY SAVING AT THE SLOWEST RATE IN 35 YEARS. THE REPUBLICAN ALTERNATIVE REVERSES THIS BIAS BY PROVIDING A FULL $2,000 SPOUSAL

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IRA, as in the President's Proposal; allowing an annual $12,000, section 401(k) contribution to for-profit employers and private non-profit employers; providing for a non-deductible IRA; and discouraging consumer debt through limits on deductibility.

Pro Private Retirement Savings: H.R. 3838 provides extensive, and in some cases incongruous, modifications to the existing maze of statutory tax restrictions governing our private retirement system. No matter how well intentioned these proposed changes may be, they are poorly timed in view of (1) the extensive revisions which this area of law has experienced, in three separate pieces of legislation, since 1982, and (2) the comprehensive review of retirement income policies now being considered by the Subcommittees on Social Security and Oversight of the Committee on the Ways and Means and other committees of the Congress. Recognizing the integral role which the private retirement system plays, with social security and personal savings, in providing retirement income security, review and revision of these provisions should be delayed. The REPUBLICAN ALTERNATIVE follows this more prudent course by including only minimal changes in this area, thus leaving for another day a comprehensive review of this important area of tax and income retirement policy.

PRO CAPITAL FORMATION: H.R. 3838 REVERSES BY 100 PERCENT (AND SOMETIMES BY AN EVEN GREATER MARGIN) THE CAPITAL FORMATION INCENTIVES ENACTED BY PRESIDENT REAGAN'S ECONOMIC RECOVERY TAX ACT OF 1981. THE REPUBLICAN ALTERNATIVE MODERATES THIS DISTURBING SHIFT BY RETAINING A 5% INVESTMENT TAX CREDIT ON DOMESTICALLY PRODUCED MANUFACTURING EQUIPMENT, SETTING THE CORPORATE ALTERNATIVE MINIMUM TAX RATE AT 20% (RATHER THAN 25% AS IN H.R. 3838) SO AS TO AVOID PENALIZING MARGINALLY PROFITABLE CAPITAL INTENSIVE BUSINESSES, PROVIDING FULL INDEXING OF DEPRECIATION AS IN THE PRESIDENT'S PROPOSAL, AND PROVIDING FOR A 28-YEAR RECOVERY PERIOD ON STRUCTURES AS IN THE PRESIDENT'S PROPOSAL. IN ADDITION, THE REPUBLICAN ALTERNATIVE RETAINS THE CURRENT LAW INDIVIDUAL CAPITAL GAINS TAX RATE OF 20% RATHER THAN INCREASING THE RATE TO 22% AS UNDER H.R. 3838.

PRO INTERNATIONAL COMPETITIVENESS: AT A TIME OF STAGGERING TRADE DEFICITS AND A SAGGING ABILITY OF U.S. COMPANIES TO COMPETE IN THE WORLD MARKET, H.R. 3838 INEXPLICABLY DECIMATES U.S. CAPITAL FORMATION INCENTIVES AND IMPOSES EXTENSIVE NEW COMPLEXITIES CONCERNING THE TAXATION OF U.S. COMPANIES DOING BUSINESS ABROAD. AS INDICATED ABOVE, THE REPUBLICAN ALTERNATIVE REVERSES THE TREND CONCERNING CAPITAL FORMATION INCENTIVES. IN

ADDITION, THE REPUBLICAN ALTERNATIVE RECOGNIZES THAT THE PROPOSED CHANGES WITH RESPECT TO THE TAXATION OF U.S. COMPANIES DOING BUSINESS ABROAD, NO MATTER HOW WELL INTENTIONED, ARE CLEARLY ILL TIMED. AS A RESULT, IT INCLUDES ONLY MODEST, GENERALLY NON-CONTROVERSIAL CHANGES.

PRO CORPORATE RATE REDUCTION: H.R. 3838 PROVIDES A TOP CORPORATE MARGINAL RATE OF 36 PERCENT PHASED-IN OVER TWO YEARS. THE REPUBLICAN ALTERNATIVE, RECOGNIZING THE IMPORTANCE OF ACHIEVING LONG-TERM CORPORATE RATE REDUCTION FOR ECONOMIC GROWTH AND EFFICIENCY, PROVIDES A PHASED-IN CORPORATE RATE REDUCTION TO 33 PERCENT, THE RATE PROVIDED IN THE PRESIDENT'S PROPOSAL, BY 1991.

PRO STATE AND LOCAL GOVERNMENT TAX-EXEMPT FINANCING: H.R. 3838 WOULD IMPOSE ADDITIONAL COMPLEX, AND IN SOME CASES CONFUSING, NEW RESTRICTIONS ON BOTH PUBLIC PURPOSE AND PRIVATE PURPOSE TAX-EXEMPT BOND FINANCING. THE REPUBLICAN ALTERNATIVE, RECOGNIZING THAT THE CONGRESS IMPOSED SUBSTANTIAL NEW RESTRICTIONS ON THE USE OF TAX EXEMPT BONDS IN 1984, GENERALLY RETAINS CURRENT LAW IN THIS AREA.

SUPER MINIMUM TAX: H.R. 3838 modifies the existing minimum tax for corporations and individuals , but still allows certain taxpayers to have net income for a current year, yet pay no tax. Permitting such a situation to continue both undermines the public's confidence in the fairness of our tax system and is inconsistent with the notion that each individual and business earning income in a given year should help participate in the cost of government. The REPUBLICAN ALTERNATIVE contains a Super Minimum Tax designed to avoid this result by requiring all taxpayers to pay some minimum amount of tax in any year in which they earn income.

While I do not wish to suggest that the REPUBLICAN ALTERNATIVE represents the only way in which to get from the "here" of present law to the "there" of tax reform with the least potential economic disruption, I do believe it has the virtue of representing a complete tax reform package, which is revenue neutral, which accommodates most if not all of President Reagan's concerns with H.R. 3838, and which accommodates many of the legitimate concerns of various important sectors of the economy with H.R. 3838. I strongly recommend it for your consideration as you embark down the mine filled road of tax reform. The detailed description follows.

The Republican Alternative is in the official committee files.

AIR PRODUCTS AND CHEMICALS, INC.
STATEMENT ON TAX REFORM
FOR SUBMISSION TO THE SENATE FINANCE COMMITTEE

A

Air Products and Chemicals, Inc., which is headquartered in Allentown, Pennsylvania, is engaged in a number of business areas that are both technologically oriented and capital intensive. The Company has followed a policy of reinvestment of earnings. Over the last 35 years, assets have increased from $3.6 million to $2.6 billion, while employment has increased from 203 to 18,700.

The testimony presented to the Committee establishes that the various proposed changes to the capital recovery system will increase the cost of investment in the United States and result in reduction in the ability of American companies to compete in the marketplace. With the thought that it could be useful for the Committee to focus on the impact of the proposals on a specific successful company, Air Products and Chemicals, Inc. (APCI) has analyzed the Treasury proposal, the Administration's proposal and H.R. 3838 to determine the impact on the Company. Under each proposal, the rate reduction and other favorable changes are more than offset by the impact of the termination of investment credit and cutback in depreciation. Further, the inclusion of incentive depreciation in a corporate minimum tax, termination of completed-contract accounting, and change in the taxation of foreign income would combine to weaken APCI's ability to compete in world markets.

Price Increases Required to Maintain Return

APCI's 5-year projections indicate that H.R. 3838 would result in a reduction in cash flow from domestic operations in an amount that is about equal to the current annual domestic capital expenditures. A reduction of that magnitude will reduce the capacity of the Company to make new investment.

To maintain current expected return on capital on new projects in existing business areas, APCI would have to substantially increase prices on production from new investment. If H.R. 3838 were enacted, without considering price increases that might be passed on to APCI by suppliers, the Company would have to increase prices from 5% to 12%, dependent on business area. In a new developing business which involves the conversion of municipal waste to energy, fees charged municipalities would have to be increased from 18% to 60% depending on the type of project.

In APCI's traditional on-site industrial gas business, the required price increase would be about 10%. Since APCI's value added in this business is about 35% of the sales price to its customers, a 10% price increase would amount to more than a 25% increase in APCI's added value portion of the price. If APCI suppliers are similarly impacted, the total price increase required through to APCI's customer could be in the area of 20%.

Price increases of the indicated magnitude are not likely to be achievable. Foreign competition is likely to set a limit on domestic and foreign price increases. If the Company cannot achieve the required increase in price levels, investment in the U.S. is likely to be reduced.

Alternative Minimum Tax

H.R. 3838 includes an alternative minimum tax (AMT) for corporations. The AMT would be computed by applying a 25% rate to alternative minimum taxable income (AMTI). For purposes of determining AMTI, depreciation on property placed in service after December 31, 1985 would be computed using the bill's non-incentive depreciation system ("INDS"). Under INDS, an asset is depreciated using straight-line depreciation over the asset depreciation range midpoint for the asset. Indexing for inflation is not permitted.

Projections indicate that as long as APCI continues to grow through investment in existing business lines, it is likely to be subject to the H.R. 3838 minimum tax. The Company would be at a competitive disadvantage with respect to foreign producers and U.S. competitors which conduct other businesses which are not as capital intensive and which generate sufficient taxable income to avoid the minimum tax provisions. A possible result would be that APCI would cut back in U.S. investment in equipment and, perhaps, move into business areas that are not as capital intensive.

The proposed system would undermine important incentives contained in the income tax laws, place the heaviest burden on those companies least able to afford the tax, and further complicate corporate recordkeeping and tax compliance. The creation of a dual-tax system based on broadened concepts of tax preferences is inappropriate, particularly while consideration of comprehensive tax reform is pending. Items that may be considered unsound should be dealt with in the context of reform rather than a revised minimum tax.

H.R. 3838 Has No Minimum Tax Transition Relief

H.R. 3838 does not provide for transition relief from minimum tax on committed projects. In APCI's case this means that minimum tax could be payable in years immediately after enactment even though the minimum tax depreciation add-back is attributable to assets that were contracted for before there was any indication that a minimum tax would reflect incentive depreciation in the taxable base.

APCI has made long-term fixed price commitments based on the law as it existed at the time these contracts were entered into. Some of these commitments were made prior to the H.R. 3838 September 25, 1985 transition rule cutoff date. Other contracts probably will have been entered into prior to any revised effective date adopted by the Senate Finance Committee. The assets necessary to perform these contracts will not be placed in use until after the general effective date. The contracts do not provide for price adjustment because of changes in the income tax law.

In recognition of the need to protect taxpayers who have entered into contracts to acquire equipment or to sell product or provide services, the H.R. 3838 provides for continuation of investment credit and ACRS where a binding contract was in existence before September 25, 1985. Similar transition rules should be adopted in any corporate alternative minimum tax provision if incentive depreciation is included in the taxable base.

Without transition relief APCI may be placed in an alternative minimum tax liability position largely because of the differences between ACRS transition deductions available for normal income tax and the non-incentive depreciation deductions used for minimum tax purposes. For example, under H.R. 3838, with respect to one pending APCI project involving cogeneration assets, the difference in depreciation during the first three years after start-up would total approximately 49% of the cost of the asset and by the fifth year the difference (which under H.R. 3838 is, in effect, a preference) would exceed 80% of the cost.

With respect to the minimum tax, at the very least, a transition rule should be adopted which would not require add-back of depreciation on assets that otherwise qualify for the depreciation/investment credit transition rules under the normal tax.

Nonconventional Fuel Credit

In 1979, Congress enacted a nonconventional fuel credit (Section 29 of the IRC) as an inducement for taxpayers to invest in facilities that would yield energy from nonconventional sources. The form of the incentive is a $3 credit per barrel of oil equivalent of qualified fuel production. The amount of the credit is adjusted to reflect inflation and the wellhead price of oil. As the value of the oil increases over $29 per barrel, the credit decreases.

Under existing law the credit is available with respect to assets placed in use prior to January 1, 1990, and with respect to production sold prior to January 1, 2001. H.R. 3838 would terminate the credit with respect to facilities placed in use after December 31, 1985, and for facilities in existence prior to December 31, 1985, would reduce the period during which the credit would be allowed to sales before January 1, 1990.

There are strong environmental and energy management policy reasons for continuing to encourage investment in facilities that capture the methane generated at waste sites and convert it into energy. The methane would otherwise pollute the atmosphere. APCI believes that the present nonconventional fuel credit provision as it applies to biomass facilities should be retained.

If the law is to be changed, from a fairness standpoint, there ought not be a cutback in the credit with respect to assets in existence before any change in the law. These investments were made in reliance on a specific incentive designed to protect those that had taken the extraordinary risk associated with nonconventional energy sources. If there is a retroactive termination of this targeted incentive, Congress can hardly expect to have full reliance on any targeted incentive that it may offer in the future.

If the law is to be changed, there should be transition relief with respect to new investments that were committed before enactment of the law but which were not put into use until after the change.

ALUMINUM COMPANY OF AMERICA
ALCOA BUILDING
PITTSBURGH, PENNSYLVANIA 15219

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ALCOA

CHARLES W. PARRY
Chairman and Chief Executive Officer

February 19, 1986

The Honorable Bob Packwood
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

> '85 Trade Deficit Is Worst Ever
> --Headline, The Washington Post, 1986 January 31

> "The extraordinary deficits we now face...hold the substantive prospect of plunging the nation into an unprecedented economic recession..."
> --Senator Pete Domenici
> The Washington Post, 1986 January 21

Many of us in the business community have been saying for some time that this nation's economic health depends on our ability to solve the twin problems of the federal deficit and the trade imbalance. As you and your committee deliberate the subject of so-called tax reform, I hope you will do so against the background of the deficit and trade problems. If you do, I am sure you and your colleagues will conclude, as have I and many of my associates, that nothing in HR3838 or the President's tax proposals addresses these problems.

To the contrary, HR3838 will destroy the modern capital cost recovery system enacted only in 1981. It will remove the most critical incentives for investment by capital intensive businesses, while those with whom we compete globally do not carry the same burden. It will unfairly shift the tax burden to the smokestack industries. This would be an enormous gamble with the health of the basic industries in this country. The aggregate effect would be to jeopardize the economic structure of those industries for the next 20 to 30 years. It is altogether possible that they may never be rebuilt.

Alcoa has pledged its resources -- financial and technological -- to keep our U.S. plants modern so that we can survive in what has become an extremely competitive business. The capital cost recovery system (investment tax credit and accelerated depreciation) has been very meaningful as we decided our strategic response to the fundamental changes in our business. I cannot say for sure that we would have done otherwise without the benefits of the investment credit and ACRS. But because of the inducements offered by other governments, I do know at the very least we would be forced to consider very carefully our non-U.S. alternatives.

I believe that the time and energy the Congress and the Administration are devoting to tax reform has served only to divert attention from the crucial economic issues posed by our deficit problems. I further believe that HR3838 is so flawed as to be irreparable. It should, therefore, be set aside.

It has become almost trite, a cliche, to say, "I support tax reform, but...". Nevertheless, we at Alcoa do support true, meaningful tax reform, but not at the expense of the nation's basic industries and not until we have faced up to the more critical budget and trade issues. After these issues have been addressed, and if in the process of reducing the budget deficit it becomes necessary to raise revenues, we should then look at the tax code. I agree with Senator Domenici that "...this country ought to approve of those things (government programs) we need and pay for them. I have trouble understanding the rationale that says [new] taxes of $25 billion judiciously applied will destroy the economy, but that tax reform that switches $150 billion in new taxes to business is okay."

Mr. Chairman, I respectfully request that this letter be made a part of the record of the hearings your Committee is holding on the House-passed tax revision legislation (HR3838).

Sincerely,

Charles W. Parry

Charles W. Parry

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AMERICAN
BANKERS
ASSOCIATION

1120 Connecticut Avenue, N.W.
Washington, D.C.
20036

James D. McLaughlin
Senior Government Relations
Counsel
202 467 5778

February 14, 1986

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
219 SDOB
Washington, D.C. 20510

Dear Mr. Chairman:

The American Bankers Association, on behalf of the more than 4,000 banks which exercise fiduciary and investment management services, is writing to express its concern over a provision in the House-passed tax reform proposal relating to the alternative minimum tax. We respectfully request this letter be incorporated into the record of the hearing which took place on February 3.

Under the House bill expenses such as investment advisory, fiduciary, custody or other fees incurred in the production of income would not be deductible in computing the alternative minimum tax. The Administration's tax reform proposal would permit these and certain other expenses to the extent they exceed 1% of adjusted gross income to be deductible. As a result, these expenses would have been taken into account in computing both the regular income tax and the alternative minimum tax.

The House bill however does not permit the deductions of these expenses even as they exceed 1% in computing the alternative minimum tax. Because many more taxpayers, under the House bill, will be subject to the alternative minimum tax this issue will become significant to many taxpayers for the first time. Further, as our population grows older increasing numbers of retired people will be dependent on their accumulated savings and investments for living expenses. For taxpayers like these who derive a major portion of their income from investments, the fees they pay for planning, investment advice, custody and other services

AMERICAN
BANKERS
ASSOCIATION

CONTINUING OUR LETTER OF

February 14, 1986

SHEET NO 2

will not be deductible. This is true even though the changes are legitimately and reasonably incurred in the production of income. We question the theoretical justification for the House position.

It would seem that the tax laws should provide greater incentive for productive investment of funds. Increased levels of investment make possible greater employment, plant modernizations and a more efficient American industry which can compete in world markets more effectively. Deterrents to increased investment as contained in the House bill should be removed and the Administration's proposal with respect to Section 212 expenses for alternative minimum tax purposes should be adopted.

Sincerely yours,

James D. McLaughlin

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American Bar Association
Section of Corporation, Banking and Business Law
Conference
Tax Reform: The Business Perspective
Wintergreen, Virginia November 7-9, 1985

A

INTRODUCTION

President Reagan established as a goal for his second term a fundamental reform of the Internal Revenue Code (the Code). Criticizing the present Code as being overly complex and inequitable, the President called for simplicity, a lowering of rates and a winnowing out of deductions, exemptions, credits and allowances.

The President's proposal (of May 29, 1985) has come to be known as Treasury II, since it was based on a prior Treasury Department Report of November, 1984, now referred to as Treasury I.

In view of the importance of fundamental tax reform to the members of the American Bar Association's Section of Corporation, Banking and Business Law, the Section Chairman, John Subak, appointed an ad hoc committee on tax reform[1].

That committee prepared a statement of the Case for Reform and Goals for Reform. It then conducted a conference on tax reform from the business perspective and submits this report of that conference.

TAX REFORM CONFERENCE, WINTERGREEN, VIRGINIA NOVEMBER 7-9, 1985

Under the sponsorship of the Section, fifty-six men and women participated. There were twenty-one lawyers in private practice, seven lawyers with corporations, six academicians, eight governmental representatives, eleven persons from business and finance and three practising certified public accountants.

The participants divided in small groups debated for one full day six specific issues relevant to business taxation. On the second day similar small groups drafted specific proposals for presentation in the final one-half day to the plenary session for final debate, revision and vote.

POSITIONS TAKEN BY THE CONFERENCE

The views expressed by the Conference are to be ascribed to the Conference as a whole and not to the American Bar Association, or any Section or Committee thereof, nor to any

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individual participant nor to any of the organizations with which the participants are affiliated.

SUMMARY OF CONFERENCE POSITIONS

1. Corporate Income Tax - While the Conference did not call for the outright repeal of the corporate income tax, it did endorse partial integration of the corporate income tax with the individual income tax by permitting corporate taxpayers a dividend paid deduction.

2. Capital Gains - The Conference found that the existing preferential treatment of capital gains is a significant factor in inducing investment and business growth and should be maintained at current levels. Further, there should be no distinction between the capital gains treatment permitted under the Code for corporations and individuals. Additionally there should be no distinction in the capital gains treatment of different categories of assets now eligible for taxation at capital gains rates. Finally, replacing the capital gains differential with indexing for inflation would be unduly complex and should not be adopted.

3. Capital Investment Incentives - While the Conference recognized the need for maintaining certain capital investment incentives for "over-riding social and economic considerations", it also concluded that such incentives have been afforded too readily. The Conference did agree -

(i) Generally business tax incentives should not be permitted which are likely to result in a pretax loss and an after tax gain;

(ii) Depletion deductions in excess of basis should be eliminated;

(iii) Industrial Development Bonds for non-public purposes should be eliminated;

(iv) ITC should be eliminated so long as the depreciable lives now in the law are retained; and

(v) Recapture of depreciation, including straight line depreciation, upon disposition of an asset is recommended for all property including real property.

4. Time Value of Money - The Conference recognized that there is a need for tax rules dealing with time value of money issues. Noting the complexity of such rules, the Conference called for high threshholds for any such rules to

become operable and recommended the simplification of the existing provisions and consolidation of those provisions in one section of the Code.

5. Inflation Indexing - The Conference agreed that taxpayers should not be required to apply indexing formulae and procedures for purposes of calculating any income tax liability.

6. Enactment and Administration of Tax Laws -

A. The need for certainty and stability in our tax laws was emphasized by the Conference and the rapidity of change was decried.

B. Targeted tax provisions based on narrow social and economic goals (as distinguished from revenue raising) were recognized as the "heart of the complexity of the system".

C. The Conference called for better administration and enforcement of our tax laws and recognized the need for greater cooperation between tax practitioners and the Internal Revenue Service (IRS). The Conference applauded the efforts of the Treasury and the IRS to promote the general goal of voluntary compliance and recommended appropriate sections and committees within the ABA maintain ongoing contact with the Treasury, the IRS and other agencies of the Government concerned with the tax system to serve as a basis for more support of taxpayer compliance.

7. Alternative Tax Sources -

A. The Conference expressed profound concern with the way Congress determines spending and tax levels. Without improvements in procedures to control spending, the Conference was most reluctant to entrust the Congress with a Value Added Tax (VAT), or even a simplified income tax.

B. Subject to the concerns expressed in the preceding paragraph, the Conference concluded that no new tax other than a VAT is feasible. A VAT should be at a single rate with regard to all goods and services and with no exclusions and no rate differentials. Concerns with regressivity should be addressed with credits and refunds administered by existing agencies.

C. The Conference did not consider a minimum corporate income tax at a high rate an acceptable source of revenue. Such a double-track system, by its nature, is complex. A minimum tax at a high rate also destroys the incentives which Congress determined were necessary in the basic system. If changes are to be made, they should be made in the basic system.

D. The Conference urged Congress to resist pressure to make any snap decisions, particularly in selecting any alternative source of revenue such as VAT. The effective date of any structural change in the tax law, such as a VAT, should be at least one year afrer date of enactment.

8. Single Track Litigation System - The Conference rejected a proposal for a single track litigation system for all tax disputes.

The Planning Group's statement of the Case for Reform and Goals of Reform, the six issues prepared for the Conference's deliberations, the full reporst of the results of the Plenary Session and a list of Conference participants follows.

THE CASE FOR REFORM

The case for tax reform has developed from a broad consensus that the present income tax, as it is written and administered, is unsatisfactory.[2] This consensus has spawned various proposals for change, including the administration proposal of May 28, 1985 described by the President on national television with the catchwords, fairness, simplicity and growth.[3] No one could catalogue all the circumstances that have produced dissatisfaction with the federal income tax, but major problem areas are identified with some regularity.

Complexity, compounded by frequency of change, is a well known major problem with the federal income tax. The results are perceived to include unnecessary costs of compliance, unfair benefits to persons with access to sophisticated advisors, the creation of disrespect for the law, major difficulties in making legitimate business and investment decisions and substantial uncertainties that unnecessarily interfere with economic activity.[4] Complexity, compounded by the accelerating rate of change, has produced advocates for revision in the tax law to make it simple, easily understood and its application known before long-term decisions are made.[5]

The present income tax system also has received widespread criticism for its effect on the allocation of resources within our society.[6] The charge is that the income tax system results in investments that would not otherwise be undertaken at the expense of possibly better alternatives and in unnecessary impediments to an efficient economy. The use of the tax system to influence economic activity also contributes to complexity and reduces revenue with the result that rates must be higher for other taxpayers.[7] Recent changes in the depreciation system, together with the investment tax credit, produced large disparities in marginal tax rates across industries.[8] Although there is agreement that there are too many economic incentives and support for the theory that the income tax should be "neutral" with respect to such matters, various groups will disagree with respect to which incentives should be retained.[9] Incentives packaged as preserving or encouraging economic growth are currently in vogue.[10] Growth promoted by the Code in one area or sector inevitably skews the allocation of capital away from a free market determination.[11]

The view is widespread that the income tax system is unfair for an enormous variety of reasons, including the belief that tax breaks or shelters are the province of the powerful or wealthy.[12] The perception is that persons in comparable circumstances should be treated alike and that special exceptions and "loopholes" make the income tax unfair.[13]

The public's view of the income tax, the determination of many to avoid taxes and some to evade taxes and the income tax's incredible intricacies have resulted in compliance problems for both the taxpayer and the Government.[14] Taxpayer attitudes have contributed to the growth of tax shelter investments and are generally thought to result in an underground economy.[15] In turn, the current Government efforts against what the IRS views as abusive tax shelters and the underground economy have consumed substantial public and private resources which could better be devoted to other purposes.[16]

The marketing of "aggressive" tax advice by professionals has created problems not only for the Government and taxpayers, but also for professionals in their relationships with the Government, their clients and investors in various enterprises. Despite Governmental standards embodied in Circular 230, increased penalties imposed by the Code, law suits against tax advisors and professional ethics opinions, these problems have continued and are, in part, attributed to the complexities and ambiguities of the current income tax.[17]

The problems associated with the federal income tax have led to suggestions for alternative means of raising revenues, such as a value added tax or a national sales tax.[18] The prospect of serious consideration of such proposals is heightened currently by large deficits which limit suggestions for reform.[19]

THE GOALS OF TAX REFORM

A consensus exists for the broad goals of tax reform. Although subject to different verbal formulations the goals for tax reform are:

(1) simplicity;

(2) predictability and stability:

(3) neutrality (transactions should not be affected primarily because of income tax considerations);

(4) fairness (taxpayers similarly situated should be taxed in a comparable manner); and

(5) ease of application by taxpayers, their advisors and the IRS.

In measuring any proposals for change, they should be tested against the achievement of these goals. Any proposals which do not promote one or more of these goals (or reduce the deficit) should be abandoned.

ISSUES FOR DISCUSSION

I. WHAT PROPORTION OF THE INCOME TAX BURDEN SHOULD BE BORNE BY BUSINESS CORPORATIONS?

In considering this issue, the following matters, among others, relevant to the corporate income tax may be considered:

(1) uncertainty with respect to its ultimate incidence;

(2) its effect on capital and its economic evaluation;

(3) the pragmatic reasons, supporting its payment;

(4) equity among corporations in various industries and with differing sizes, capital structures and characteristics;

(5) recommended tax brackets and rate structures for corporations;

(6) the relative treatment of business partnerships;

(7) the relative treatment of S corporations;

(8) special treatment of some kinds of entities, such as mutual funds, real estate investment trusts, personal holding companies;

(9) individual tax brackets and rate structures, and, the consequences, of double taxation; and

(10) the rate of savings by corporations that contributes to new investment compared with the savings to be expected of individuals receiving tax cuts.

II. WHAT DIFFERENTIALS, IF ANY, SHOULD BE RETAINED IN THE INCOME TAX FOR CAPITAL GAINS?

In considering this issue, the following matters, among others may be considered:

(1) the importance of capital gains in inducing investment in new business;

(2) whether passive commodity investments (e.g. gold) should receive the same capital gain treatment as direct investments in business enterprises;

(3) what rate and holding period should be required to qualify for differential rates;

(4) should all suppliers of capital to all industries receive the same differential rate;

(5) the effect of differential rates for capital gains on tax revenues; and

(6) treatment of capital losses and losses on sale of business assets (Section 1231).

III. WHAT CAPITAL INVESTMENT INCENTIVES, IF ANY, ARE SUFFICIENTLY CONSISTENT WITH THE GOALS OF TAX REFORM THAT THEIR RETENTION IS RECOMMENDED?

In considering this issue, the following investment incentives and their consequences, among others, may be considered:

(1) ACRS;

(2) liberal rules for expensing items;

(3) investment credits;

(4) R&D credits;

(5) other credits; and

(6) depletion.

IV. WHAT CURRENT OR PROPOSED TAX PROVISIONS CONTRIBUTE UNDUE COMPLEXITY AND BURDENS ON TAXPAYERS AND SHOULD BE ELIMINATED?

Without limiting the enumeration of others, the following current and proposed provisions should be considered:

(1) the time value of money, including the 1984 original issue discount provisions and similar provisions;

(2) the proposals to compel cash basis service organizations to pay tax on the accrual basis;

(3) all tax provisions differing from generally accepted accounting principles;

(4) attempts to tax unrealized appreciation;

(5) all proposals involving bookkeeping costing more than the revenue to be collected;

(6) proposals and provisions involving unwarranted intrusions into personal privacy not warranted by a rational tax system; and

(7) all indexing to be done by taxpayers.

V. WHAT CHANGES ARE REQUIRED IN THE WAY TAX LAWS ARE ENACTED AND ADMINISTERED IN ORDER TO ACCOMPLISH THE GOALS OF TAX REFORM?

In considering this issue, the following matters, among others may be considered:

(1) impact of high marginal rates on tax shelters preferences, loopholes and complexity;

(2) restraint to be exercised by Congress in making changes in the tax law;

(3) avoidance of hidden agendas, such as subsidies, tax increases or decreases;

(4) restraint of the Administration in proposing changes;

(5) influences of special interests that contribute to perceived unfairness and complexity;

(6) issuance of Treasury regulations on a timely basis;

(7) unnecessary filing and paper work requirements;

(8) retroactive changes;

(9) collection of tax on the underground economy;

(10) elimination of tax shelters which have no independent economic justification;

(11) encouragement of taxpayers and their advisors to comply promptly with tax laws; and

(12) steps to induce more public acceptance of the citizen's obligation to pay taxes.

VI. WHAT ALTERNATIVES ARE AVAILABLE TO THE CORPORATE INCOME TAX AND SHOULD THEY BE ADOPTED?

In considering this issue, the following matters, among others may be considered:

(1) whether another source of revenue is required to enable us to afford or enact federal income tax reform satisfying the goals of tax reform;

(2) other taxes now borne by corporations including employment taxes;

(3) a corporate consumption tax;

(4) a gross receipts tax;

(5) value added tax;

(6) a national sales tax; and

(7) other proposals.

PROPOSALS OF THE PLENARY SECTION

The foregoing six issues were the subject of one full day's discussion and debate by six "discussion groups" and one further day's deliberation in six "drafting groups." The proposals emanating from each drafting group were submitted to the plenary session on the last one-half day for further debate, revision and adoption or rejection. Those proposals set forth below were adopted unanimously or by a substantial preponderance of those participating in the plenary session.

ISSUE GROUP I. WHAT PROPORTION OF THE INCOME TAX BURDEN SHOULD BE BORNE BY BUSINESS CORPORATIONS?

1. The corporate income tax should be integrated with income taxes imposed on individuals.

Reasons: The integration of the corporate income tax to reduce double taxation received strong support because of the perceived unfairness in taxing corporate sector income more than income earned by partnerships, individuals or S corporations which compete with taxpaying corporations both in the market place and for new investment. Integration also received strong support because the present tax laws encourage the use of debt with the result that capital structures are unduly leveraged. Integration also is expected to reduce impediments to capital formation and increase economic efficiency. Present law provides a strong incentive to retain earnings in the corporation even though the corporation does not have the optimum economic use for the funds. In summary, the Conference concluded that the tax law should not continue its discrimination against the corporate sector but should be neutral with respect to the form of the business enterprise and reduce existing incentives for debt financing and retention of corporate earnings.

2. This integration should be advanced by a corporate dividend paid deductions.

Reasons: The Conference concluded that integration should best be advanced at this time by a corporate dividends paid deduction. Proposals for achieving full integration were considered but rejected as too complex to warrant adoption. The Conference concluded that the dividends paid deduction was the simplest method of achieving partial integration and would not change the relative treatment of shareholders, whether low-bracket, tax-exempt or otherwise. Corporations having need to retain funds could do so with dividend reinvestment plans.

3. Revenue loss due to partial integration should be replaced by limitations on tax credits and other allowances.

Reasons: The Conference concluded that integration of the corporate and individual income tax should be a high priority goal for Congress because of fairness, economic efficiency and the advisability of reducing tax incentives for leveraged financing. Consistent with that position, the

Conference concluded that revenue actually needed for the efficient operation of the Government should not be raised by double taxation, but by changing other provisions of the tax laws.

ISSUE GROUP II. WHAT DIFFERENTIALS, IF ANY, SHOULD BE RETAINED IN THE INCOME TAX FOR CAPITAL GAINS?

1. Because the capital gains differential is a significant factor in inducing investment and business growth, the preferential treatment of capital gains should be maintained at or near its present level in spite of the complexities it fosters.

Reasons: The capital gains differential and rules to limit its application are sources of great complexities in the Code. Notwithstanding, the strong consensus of the Conference was that the differential is so essential and efficient as an investment incentive necessary to fuel business growth that it should be retained at essentially current levels. Many who supported this conclusion expressed the view that the differential would probably be less important in the event the highest marginal rate were sufficiently low, such as 10%, while others insisted that the differential is necessary regardless of rates.

2. Because corporations are a significant source of investment capital, the capital gains treatment for corporations should be the same as it is for individuals.

Reasons: The Conference could see no justification for differentiating the tax treatment of capital gains between corporations and individuals.

3. The current holding period for long term capital gains should be retained to promote high risk investment, mobility of capital, consistency and predictability.

Reasons: A relatively short holding period provides necessary liquidity and thus supports risk investment by promoting marketability. The group was equally supportive of six months or one year in the abstract, but in view of the confusion and disruptions resulting from past changes, the sense of the Conference was that in the interest of consistency and predictability the present six months holding period should not be changed.

4. Replacing the capital gains differential with indexing for inflation would fail to address the investment

incentive aspect of the differential, would be unduly complex and should not be adopted.

Reasons: The capital gains differential has often been supported as a "rough justice" adjustment for taxing at a reduced rate gains resulting primarily from inflation. Recognizing the need for such an adjustment, proposals have been made in the past to replace the capital gains differential with an indexing system which, it is contended would more accurately reflect inflationary gains and losses. The Conference was virtually unanimous in rejecting the indexing approach as unduly complex and burdensome to taxpayers, especially individuals and small business. More importantly, this approach was rejected as failing to provide the necessary investment incentive offered by the differential.

5. Notwithstanding that different classes of capital assets may contribute in different degrees to the objectives of the capital gains differential, varying the tax treatment of gains from such assets would likely be unduly complex and not justified by the resulting minimal impact on revenue.

Reasons: Discussion focused on the differing contributions to growth made by business assets and securities on the one hand and objects of art, precious metals and antiques and other collectables on the other. While detailed rules might be carefully crafted to recognize any clearly perceived differences, the sense of the Conference was that such an effort would necessarily produce unduly complex and controversial rules, a result probably not justified by its effect on revenues.

ISSUE GROUP III. WHAT CAPITAL INVESTMENT INCENTIVES, IF ANY, ARE SUFFICIENTLY CONSISTENT WITH THE GOALS OF TAX REFORM THAT THEIR RETENTION IS RECOMMENDED?

1. Generally it would be best if investments were made without regard to tax laws, credits and other special incentives which distort the allocation of economic resources and complicate the tax laws. They should only be provided where there are overriding social or economic considerations.

2. Distortions inherent in the current and any likely future U. S. income tax system (including a bias in favor of consumption and housing) and arising from other economic forces, require retention of investment incentives.

3. Lower tax rates diminish the need for, and impact of, business investment incentives.

Reasons: The consensus on the first three issues developed after considerable debate, both in the drafting group and again in the plenary session. That discussion reflected the view that under the current and any likely future income tax system, although far from ideal, it is necessary to provide investment incentives. This view is based in part upon the perception that under our tax system there are inherent and legislated distortions which need to be balanced by incentives to stimulate investment if our economic system is to be effective. Generally, encouragement of investment and savings, rather than consumption, was considered more important to economic growth of the economy and control of inflation.

The debate acknowledged the complexity added by these incentives and considered whether these incentives could better be provided by other means or other governmental agencies. The reluctant conclusion was that the tax system was the most effective place to adopt and administer these incentives. The use of other means would likely mean new bureaucracy and probably greater complexity and inefficiency. The Conference also acknowledged that from time to time there may be a need for tax incentives to counteract the effect of other national or international economic distortions, and that the income tax system lends itself to prompt response to such distortions.

The tenor of the discussion also evidenced the practical estimate that we are unlikely to have total reform which would eliminate existing distortions or reduce their significance to a negligible level. In this connection it was also recognized that while creating such incentives may result in dislocations in some quarters, to the extent that tax rates were lowered such dislocations would be diminished. It was hoped that such lowering could be achieved and the need for incentives diminished.

Introductory Comment to Proposals 4 through 10

Write-offs and tax credits reflecting recovery for the taxpayer in excess of cost (including particularly tax shelter investments where concern for the tax benefits often exceeds focus on economic growth or gain) were generally viewed as a source of unfairness and undue complexity and a principal area requiring reform. Such write-offs and credits to the extent they exceed costs were viewed as a subsidy and should be disfavored in the absence of a strong countervailing social or economic need. The drafting group also considered the apparent bias in favor of service businesses which expense rather than capitalize what may be viewed as long term investments and against manufacturing businesses which are obliged to capitalize their investments. Based on these perspectives the recommendations set forth below in Items 4 through 10 were presented by the drafting group and adopted by a substantial majority of the plenary session.

4. Generally business tax incentive should not be permitted which are likely to result in a pretax loss and after tax gain.

Reasons: The so-called "negative tax" effect was viewed as inconsistent with the goals of tax reform. It induced investments based on tax savings rather than sound business prospects. The result is economic distortions and unfairness. The drafting group which authored this proposal took exception to tax provisions resulting in recovery of more than costs over the write-off period whether arising from deductions or credits.

5. Depletion deductions in excess of basis of the property should be eliminated.

Reasons: This proposal was considered with Item 8 below dealing with deduction of intangible drilling costs. The deduction under this item was generally viewed as a type of incentive which was unfair, had the potential of producing a negative tax and induced tax motivated rather than growth motivated investments.

6. Industrial development bonds for non-public purposes should be eliminated.

Reasons: The Conference view was that the use of industrial development bonds or industrial revenue bonds for essentially private purposes has been abused, was excessive and has not provided the anticipated degree of economic benefits.

7. A. Investment tax credit should be eliminated.

Conference approved with a very few in dissent. (Mr. John Mendenhall requested to be recorded in dissent.)

B. ACRS as currently allowed for tangible property other than realty be continued.

Reasons: Tax credits were viewed as generally excessive and unfair and leading to negative tax effects. Assuming elimination of the tax investment, credit, the continuation of the ACRS was favored as a reasonable, simple and balancing incentive, with the shortness of term for the writeoffs counterbalancing costs arising from the continuing, if modest, rate of inflation.

8. Permitting current deduction of intangible drilling costs is recommended.

Reasons: As distinct from depletion deductions the deduction of intangible drilling costs was seen as true cost recovery and an appropriate incentive for the risks involved.

9. With respect to realty improvements and buildings and tangible personal property, recapture of depreciation (including straight line) upon disposition is recommended.

Reasons: Consistent with the basic perspectives described above, recapture was viewed as eliminating unfair distortion.

10. With regard to R & D expensing and credits, it is recommended to continue R & D expensing as presently allowed, to eliminate present R & D credit provisions, and to add a well constructed alternative R & D tax credit incentive.

Reasons: Permitting R & D expensing and some form of credit reflected support for an overriding economic goal, inducing business creativity with resultant growth and jobs. The R & D credit was considered overly complex and difficult to apply. It should be reconstructed to simplify its provisions and continue its application.

11. Indexing is not recommended at this time.

Reasons: Indexing in connection with depreciation deductions or other investment incentives was not favored. It was considered as extremely complex and as building into the tax system an adjustment to an economic ill rather than seeking a cure for that ill.

ISSUE GROUP IV. WHAT CURRENT OR PROPOSED TAX PROVISIONS CONTRIBUTE UNDUE COMPLEXITY AND BURDENS ON TAXPAYERS AND SHOULD BE ELIMINATED?

1. The rules dealing with the time value of money should have a higher threshhold before becoming operable, and the current provisions should be simplified and consolidated in one section of the Code.

Reasons: It is recognized that there is a need for tax rules dealing with the issues of time value of money. The time value of money computations are complex, particularly in view of the requirement of compounding interest and changes in principal balances and the changing applicable rates of interest. Accordingly, to relieve small businesses and individuals from such burdensome calculations, rules dealing with time value of money should have significantly higher threshholds. Further, the current provisions now scattered among several sections of the Code should be simplified and consolidated into one section.

2. There should be a greater conformity of tax accounting to generally accepted accounting principles in the taxation of business entities; there should be a presumption that generally accepted accounting principles apply unless inconsistent with the express statutory provisions of the Code.

Reasons: The regulatory and judicial processes have introduced modifications of accrual accounting for tax purposes beyond those required by specific provisions of the Code. GAAP represents a fairer and more accurate starting point in computing taxable net income. For example, prepaid income should not be taxable as it creates a mis-matching of cost and revenue.

3. Generally taxpayers should not be required to recognize gain prior to realization.

Reasons: Taxation of unrealized appreciation would introduce a new area of complexity into the administration of the tax laws, involving appraisals and valuations beyond those now required. The taxation of the unrealized appreciation would impose a burden on taxpayers by requiring them to pay taxes without related cash flow available for the purpose.

4. Taxpayers should not be required to apply indexing formulae and procedures for purposes of calculating income tax liability.

Reasons: It is recognized that some type of indexing is necessary to overcome the effects of inflation and to prevent "bracket creep," where inflation rather than true income is taxed. However, all such adjustments should be built into the rate tables, including exemptions and the standard deduction. Any requirement for taxpayers to apply indexing formulae, as, for example, to bases of assets in computing gains, is too burdensome and can be best handled by rate differentials.

ISSUE GROUP V. WHAT CHANGES ARE REQUIRED IN THE WAY TAX LAWS ARE ENACTED AND ADMINISTERED IN ORDER TO ACCOMPLISH THE GOAL FOR TAX REFORM?

1. The over-riding goals in improving the processes of legislation and regulation should be to strive for a reasonably understandable law that can be interpreted without excessive costs relative to the costs of the transaction involved.

Primary needs at the present time are certainty and stability. A concerted effort to educate Congress, the Treasury and the public to this need should be undertaken.

2. The use of the Code to achieve targeted social and economic objectives is at the heart of the complexity of the system and is primarily responsible for many of the problems of uncertainty, enforcement and administration. Congress should exercise substantially more restraint in utilizing the income tax to achieve such objectives.

Reasons: Targeted provisions of the Code, resting upon narrow social and economic bases, place an inordinate strain on the tax system. The Conference felt that such provisions should be regarded as exceptions, justifiable only by compelling circumstances. Under our representative government, Congress serves as the proper medium for deliberating such provisions. While an outright ban was not recommended, the Conference urged "substantially more restraint."

3. A. Tax laws should not be changed as frequently in the future as they have been in the past. Wholesale revision should not take place more frequently than every ten years. Targeted revisions to specific areas should not take place more frequently than every two years and then only after the proposed revisions have been thoroughly studied by interested professionals and trade groups, (e.g., Subchapter S Revision Act of 1982).

Reason: Since 1975 there have been six major tax bills enacted (in 1975, 1976, 1978, 1981, 1983 and 1984) and a seventh is currently pending. The backlog of 437 regulation projects at the time of the Conference (368 in Legislation and Regulation and 69 in Exempt Organizations) indicates the Government is behind in implementing these changes. While there is no comparable index to judge private sector absorption of this material, the experience of American Bar Association members is that both practitioners and clients are having difficulty in keeping up with changes of this magnitude and frequency. This recommendation proposes a possible timetable for major and minor tax revisions as a basis for discussion of whether such cycles would be acceptable and practicable in the administration of the tax law. Such a cycle would also facilitate increased consultation with professional practitioners, and trade groups, which is recommended in Items 4 and 10.

B. There should be no sunset provisions in tax legislation. However, if Congress does use sunset provisions, it should at least limit such provisions to legislative actions which are a direct response to a national emergency (e.g., the energy crisis).

4. Concerted efforts should be made to improve the public perception of our tax laws and those administering the tax laws. These efforts should include:

(a) Adequate funding of the IRS, to provide more education and training;

(b) Redirecting enforcement efforts toward (i) criminal enforcement, (ii) the underground economy, and (iii) the percentage of tax returns examined;

(c) Reducing substantially the adversarial attitude between the Internal Revenue Service and tax practitioners; and

(d) Encouraging ongoing contact between the Internal Revenue Service and the entire tax practitioner community.

Reason: Effective administration builds confidence in the tax system. The Conference believed that administration of the tax laws should be a higher priority with professional and practitioner groups and with the public at large. Related recommendations are found in Item 6 and Item 10.

5. The adoption of rational policy guidelines on the use of transition rules will help to make tax legislation more rational and palatable.

Because of inefficiencies during transition periods, delayed effective dates are only advisable when immediate effective dates will cause serious administrative problems.

Retroactive effective dates (defined as an effective date before enactment date) should never be used. There may have been instances in the past where retroactive implementation dates were required, legislation containing rational transition rules will minimize or eliminate the need for retroactive effective dates.

Reason: Retroactive application of law was felt to be one of the most flagrant breaches of fairness and orderly administration of the tax laws. The Conference felt that there may be circumstances justifying warnings by high Administration or Congressional officials that the tax law may be changed, but that the uncertainty over the actual language, between the time of the warning and the enactment of the legislation, argue for treating this problem by way of transitional rather than retroactive rules.

6. Higher priority in the next several years should be given to eliminating the regulation backlog. More Treasury and IRS resources should be devoted to the regulatory process; and the assistance of outside experts in this endeavor should be increased.

Reason: The absence of regulations leaves practitioners and business taxpayers in a state of uncertainty, and discourages informed compliance with the tax law. The backlog of regulatory projects has now grown to 437, an indication of a major problem in this area. The recommendation was thought to be balanced, in calling for increased resources both from inside and outside of the government to be devoted to this situation.

7. The IRS should be included in the Equal Access to Justice Act (Public Law 99-80).

Reason: Making the IRS accountable for its decisions under the Equal Access to Justice Act, would, as with other agencies, promote fairness, particularly with small business taxpayers. It would place the IRS on an equal footing with other departments and agencies subject to this law.

8. Partnership Return Filing. The Partnership tax return (Form 1065) should have a filing date of March 15 each year, or, in the case of tax years other than the calendar year, 2 1/2 months after the close of the tax year.

9. Cost/benefit analyses should be undertaken in connection with the legislative and administrative efforts to collect taxes due from abusive tax shelter participants, non-filers, and participants in the underground economy. In devising the most cost effective enforcement mechanisms, explicit recognition should be given to costs which would be incurred by law abiding taxpayers.

Reason: The principles of cost-effectiveness should be elevated in tax administration, in order to promote techniques which have more impact on non-compliers and less impact on complying citizens.

10. The efforts of the Treasury and IRS to encourage citizens to assume their obligations to pay taxes and promote the general goal of voluntary compliance with the tax laws

should be supported. Appropriate sections and committees within the ABA should maintain ongoing contact with the Treasury and IRS for purpose of gaining information that can serve as a basis for more informed support of these efforts.

ISSUE GROUP VI. WHAT, IF ANY, ALTERNATIVES TO THE CORPORATE INCOME TAX SHOULD BE SERIOUSLY CONSIDERED?

1. Without fundamental changes in the way Congress determines spending and tax levels, Congress should not consider alternative revenue sources. It should instead move to broaden the base of the existing tax system while lowering rates.

Reasons: Our present deficit arises in large part because of the failure of Congress to limit expenditures to match available revenue. Reform of the income tax laws should be accomplished by broadening the base of the existing tax system while lowering rates. Income tax reform should not be carried out by looking for new sources of revenue outside the income tax system.

2. In the unlikely event that restraints on spending can be established, a VAT is viewed as preferable to income taxes and should be considered to reduce or eliminate taxes on income.

Reasons: If an additional revenue source is needed, a VAT is preferable to income taxes or minimum taxes and should be considered rather than a corporate income tax with high rates. A minimum corporate income tax is highly undesirable as a source for additional revenue. Such a "double-track" tax system, by its nature, adds to the complexity of the law. A minimum tax at a high effective rate also destroys the incentives which Congress determined were necessary in the basic system. If changes are to be made, they should be made in the basic system.

3. Profound concern is expressed with the spending practices of Congress, and the Conference is reluctant to entrust it with an efficient revenue raising vehicle such as VAT or simplified income tax.

Reasons: The strongest argument against VAT is the efficiency of such a system and the ease with which rates can be raised and additional money collected if Congress is unwilling or unable to control spending.

4. No new tax other than some form of VAT is considered feasible. The tax on value added should be at a single rate with respect to all goods and services with no

exclusions and no rate differential. Border adjustments employed for international business and conventional VAT arrangements should be utilized. Concerns with regressivity should be addressed by credits and refunds administered through existing agencies.

Reasons: Other possible tax sources, such as another consumption tax, a gross receipts tax, or a national sales tax, would interfere with revenue sources traditionally left to state and local governments. Such taxes also distort economic decisions and, because of a pyramiding effect, encourage inflation. Under a VAT there is no pyramiding because a deduction is available for goods previously taxed.

Taxing value added at a single rate with respect to all goods and services with no exclusions and no rate differential would make the tax easy to administer and avoid the special rate and exemption provisions which have so greatly complicated the income tax law.

5. Congress should resist pressure to make snap decisions, particularly in selecting any alternative source of revenue such as VAT. The effective date of any structural change in the tax law should be at least one year after the date of enactment.

Reasons: Experience with the corporate income tax law has proved that snap decisions make bad law. Particularly in the case of any structural changes in our tax law -- such as adoption of a VAT -- all questions of substance should be considered before enacting a law. In order to provide time for both the government and taxpayers to establish satisfactory compliance procedures, the effective date should be at least one year after the date of enactment.

EPILOGUE

The "Case for Reform" and the "Goals of Reform" clearly point to the problems of the existing Code, its complexities, difficulties of administration and the like. The Planning Group did not endeavor to direct the Conference either on the path of pure reform or on the path of doing what may be politically "do-able" or economically advisable (even assuming it could so direct participants who volunteer their time and expense).

The progession of events from Treasury I to Treasury II to the activities of the House Ways and Means Committee (in its final throes during the Conference) could not have given the participants confidence that anything approaching reform - in its customary meaning - would be forthcoming. Not surprisingly then, some recommendations of the Conference would retain certain investment and business incentives, with their inevitable complexities.

The Conference did strike at existing complexities which may produce "negative taxation" by recommending -

- the elimination of ITC, coupled with the recommended retention of the current ACRS schedules,

- the elimination of deductions in excess of basis, and

- the recapture of depreciation (including straight line) upon disposition of buildings, improvements and tangible personal property.

The Conference did demonstrate its concern about the complexities of and frequent changes in the Code.

- It called for partial integration of the corporate and individual income taxes by permitting a dividend paid deduction.

- It rejected any statutory distinction between categories of assets available for capital gains treatment.

- It rejected any taxpayer indexing for inflation.

- It recommended greater conformity of tax accounting to generally accepted accounting principles.

How the Conference would have reacted to these issues if there were a real prospect of low individual income tax rates and low corporate tax rates cannot be predicted. There was a hint from the Capital Gains Group that perhaps preferential treatment would not be needed to sustain investment if the individual rates were in the area of 10%. The Capital Incentive Group noted that lower corporate rates reduce the need for business incentives, as well as their impact.

Substantial reductions in rates and simplification are not now in sight. The Conference did unquestionably express grave concern about the rapidity of changes in the Code. Given stability, the IRS, tax practitioners and the courts have demonstrated abilities to interpret and administer difficult and complex tax provisions. The stated goals of predictability and stability would be served through no change at all. While there are indications that the Conference would have favored no change over increasing complexities coupled with somewhat lower rates, such cannot be stated with certainty.

And that is one question we would present to the Conference - if we had it to do over again.

FOOTNOTES

[1] The Committee as originally appointed consisted of the incumbent Chairmen of the Section's Committees on Corporate Taxation, Weaver Dunnan, Small Business, William L. Taylor, Employee Benefits and Executive Compensation, Roger Siske, Law and Accounting, Abraham Stanger, and Henry Wheeler, a former Section Chairman. That Committee added the following members: Incoming Chairmen of the Committees on Corporate Taxation, Donald Harkleroad and Small Business, Richard Cherin, former Chairman of the Committee on Partnerships and Unincorporated Associations and member of the Council, Albert Cardinali, member of the Committee on Small Business, Herbert Spira, former member of the Council and member of the Committees on Corporate Laws and Small Business, Richard E. Deer, and member of the Committees on Small Business and Federal Regulation of Securities, Simon Lorne.

[2] The Gordian Knot, Wall St. J., April 3, 1985, at 30, col. 1; Taxation Sensation, New Republic, December 24, 1984, at 5; and Fallows, Endless Spending, Atlantic, April, 1984, at 18.

[3] Rowen, T-1 Was Better, Washington Post, May 30, 1985, at A21.

[4] Grotesqueries, Wall St. J., April 11, 1985, at 30, col. 1; Kinsley, Itemized Intransigence, New Republic, December 31, 1984, at 6.

[5] Brownstein, Wagering on Tax Reform, Nat'l J., February 2, 1985, at 30.

[6] Feldstein, The Welfare Cost of Capital Income Taxation, 86 J. Pol. Econ. 29 (1978); and Reston, Politics and Taxes, N.Y. Times, December 16, 1984, §4, at 21, col. 6.

[7] Oosterhuis, High Technology Industries and Tax Policy in the 1980's, Nat'l J., January 1, 1983, at 45.

[8] Auerbach, Corporate Taxation in the United States, Brookings Papers on Economic Activity, 2:1983 (Washington, D.C.; Brookings, Institution, 1984), at 451-513.

[9] Stern, How About Capital Gains? N.Y. Times, June 13, 1985, §A at 35, col. 1; and All Deliberate Speed on Tax Reform, Bus. Wk., June 17, 1985, at 170.

[10] Democrats Cry Foul Over Business Tax Breaks In Reagan Plan, Seek to Reclaim 'Reform' Issue, Wall St. J., May 22, 1985, at 62, col. 1; and Will, Wow! 'Populist Conservatism', Washington Post, May 30, 1985, at A21.

[11] Lodge & Crum, *U.S. Competitiveness: The Policy Tangle*, Harv. Bus. Rev., Jan.-Feb. 1985, at 34.

[12] Goode, *Lessons From Seven Decades of Income Taxation*, and Graetz, *Can the Income Tax Continue to be the Major Revenue Source?* both in OPTIONS FOR TAX REFORM (Pechman, ed., Washington, D.C.; Brookings Institution, 1984).

[13] *Sen. Dole's Good Fight*, June 25, 1982, Washington Post, at A30.

[14] Ross, *Why the Underground Economy Is Booming*, Fortune, October 9, 1978, at 92, and *I.R.S. Turns Up the Heat on Tax-Shelter Abuse*, N.Y. Times, March 3, 1985, §12, at 40, col. 2.

[15] Simon, *Radical Tax Reform*, N.Y. Times, February 28, 1982, §4, at 19, col. 1.

[16] *Tax Shelter Crackdown Begins to Have an Effect*, N.Y. Times, October 1, 1984, §D, at 1, col. 1.

[17] Holden, *Treasury Wages War on Abusive Tax Shelters*, Legal Times, October 25, 1982, at 11.

[18] Thurow, *Reagonomics and Interest Rates*, Newswk., September 21, 1981, at 38; and Safire, *The Newest Federalism*, N.Y. Times, January 26, 1982, §A, at 23, col. 5.

[19] *The Value-Added Tax; No Fiscal Cure-All*, N.Y. Times, December 8, 1981, §A, at 31, col. 1; and *Defuse the Deficit Crisis Now*, Bus. Wk., March 26, 1984, at 146.

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STATEMENT OF AMERICAN BUS ASSOCIATION TO THE SENATE FINANCE COMMITTEE ON THE TAX REFORM INITIATIVE

The American Bus Association is the national trade association for the intercity bus industry. The Association has a membership of nearly 3,500, including bus owners and operators as well as suppliers and others engaged in travel and tourism. The bus industry has become a vital element and in some cases, the lifeline for travel and tourism which contributes $140 billion annually to the nation's economy and is a foremost business generator in nearly every state.

The Association is concerned with the direction of the tax reform initiative currently under consideration by the Senate Finance Committee because the outcome will have a significant impact on our members' ability to stay in business and promote service to the public. It should be noted that the bus industry has been hit with catastrophic insurance cost increases, and if the industry is confronted with a deleterious tax environment, many small operators will go out of business. The ABA supports the effort to reform and improve the tax system and will continue to work to preserve the parts of the system we favor and to modify or eliminate the provisions that we see as being ill-conceived.

The ABA strongly supports the reduction of corporate and individual income tax rates, and supports the retention of a modified graduated rate structure for small corporations. In addition, the Association supports the maintenance of a capital recovery system that allows for the recovery of the cost of depreciable assets and for accelerated recovery of the cost of equipment. If the Senate were to move toward abolition of the investment tax credit as the House has, then the depreciation schedule for equipment should be improved over the House version. The Association believes that these proposals offer significant investment incentives and provide a stimulus for economic growth.

The House tax bill, H.R.3838, repeals the investment credit for property placed in service after December 31, 1985. As currently structured, the investment credit encourages investment in new equipment and is of major importance to Association members. Repeal of the investment credit would increase the effective cost of new equipment and would have an adverse impact on the operations of many bus lines. The investment credit helps to reduce the risk of investment in equipment that rapidly declines in value. Equipment intensive industries, such as bus lines, face a dramatic increase in the cost of new equipment. Thus, the repeal of the investment credit presents a substantial disincentive for investment and economic growth.

The Association believes that it is counterproductive to raise the taxes of companies that have made and continue to make commitments to expansion through substantial investments in new equipment. The repeal of the investment credit would abruptly raise taxes on capital investment. This increase would lead to a decrease in business investment by bus companies in capital and a decline in the growth of many bus lines.

The Association strongly supports retaining capital incentives provided by current law. Repeal of the investment credit in the House bill would effectively increase the cost of capital and slow bus company fixed investment. The bus industry's ability to serve the public's transportation needs will be dramatically impaired. To prevent this adverse impact on the bus industry and the national economy, the Association strongly supports retaining the investment tax credit, in whole or in part.

The House bill calls for the repeal of the accelerated cost recovery system for assets placed in service after December 31, 1985. ACRS would be replaced by the Incentive Depreciation System (IDS). The Association supports the basic concept of IDS and advocates maintaining a depreciation system that provides an accelerated stream of depreciation deductions over a relatively short recovery period. The success of many bus lines depends on rapid depreciation of buses and other equipment. However, IDS does not provide a sufficient stimulus for investment in new equipment.

Repeal or significant reduction of the investment credit will have an adverse impact on Association members and the economy as a whole. The repeal of both the investment credit and ACRS would have a cumulative negative impact on Association members. When coupled with the loss of the investment credit, implementation of IDS depreciation system does not provide sufficient incentives for capital investment. The House Bill will raise taxes on businesses that make significant investments in equipment. The Association advocates maintaining a more favorable depreciation system to help counter the impact of repeal or reduction of the investment credit.

The business energy credit for investment in qualified intercity buses was allowed to expire on December 31, 1985. The current shrinkage in train and air travel has caused a growing demand for bus transport. The business energy credit decreases the cost of expanding bus fleet capacity, allowing Association members to better serve public transportation needs. The business energy credit facilitates expansion of bus service, benefitting local economies through increased trade and tourism. The expiration of the energy credit will dramatically increase the cost of investment in new buses, making it more difficult for bus lines to meet growing demands. The Association strongly supports the extension of the business energy credit for qualified intercity buses. The national interest in energy conservation is still paramount.

Most of the provisions of the House bill take effect January 1, 1986. Although both the House and Senate have passed non-binding resolutions calling for an effective date of January 1, 1987 for many provisions in the House Bill, no action has yet been taken to implement these resolutions. The Association strongly urges that the Congress codify the resolution on effective dates. The uncertainty over the possible application of many of the provisions of the House bill has made investment and business planning impossible for many bus lines. The effective cost of new equipment depends on the application of the investment credit, depreciation and tax rates. The uncertainty caused by the effective dates in the House Bill has made new investment in capital uncertain. The inability to plan has caused a slowdown in investment by many bus lines. This slowdown will have a adverse impact on the ability of bus lines to meet the public's transportation needs. The Association calls for a codification of an effective date of January 1, 1987 for any tax reform legislation to enable its members to plan for the future of their businesses.

The tax reform initiative is designed to be revenue neutral. A new revenue measure may be necessary to maintain the revenue neutrality of the bill. If such measure is adopted the bus industry should not be singled out for any increased tax burden.

The bus industry has suffered a number of severe shocks in recent years. Since deregulation of the industry occurred bus lines have faced increasing costs. Association members have been forced to compete with subsidized entities such as tax exempt organizations such as mass transit districts who compete with us for charters and, of course, Amtrak which has been subsidized about $35 a passenger. In addition, there is an insurance crisis in the industry, as with other businesses. This crisis has dealt a severe blow to Association members and has dramatically increased the cost of operations. Many bus lines have been forced to cut their routes and eliminate needed public transportation. A tax increase at this time would cripple a industry already struggling to cope with increasing economic pressures. Current law provides for a refund or tax credit for part of the diesel fuel tax for bus lines. The Association strongly supports retaining the diesel fuel tax refund and credit.

Finally, the Association maintains that the House bill has gone too far in the reform of the taxation of fringe benefits. The Association opposes the imposition of non-discrimination rules on the provision of fringe benefits for employees. These rules would make it increasingly difficult for employers to provide benefits for employees, and would be disadvantageous to all employees.

Section 401(k), cash or deferred plans, provide important savings opportunities to all employees. Statistics have shown that 401(k) plans are extremely popular plans, and that many employees take advantage of them. The Association opposes the modification to Section 401(k) plans. The curtailment of employee plans such as 401(k) plans and increasing reliance on the federally controlled retirement systems decreases the workers' self reliance and removes a significant savings incentive. For this reason, the Association supports the retention of private initiative retirement savings plans.

In addition, the Association opposes the taxation of educational benefits provided to employees by employers. Taxation of these benefits is a substantial disincentive to employers providing necessary educational benefits to their employees.

1164e

STATEMENT

OF

K. MARTIN WORTHY
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Before the Senate Finance Committee, February 1986

My name is K. Martin Worthy. I am a former Chief Counsel for the Internal Revenue Service and a former Chairman of the Tax Section of the American Bar Association, and have been a practicing tax lawyer for over thirty years. I am here today, however, in my capacity as Chairman of the American College of Tax Counsel.

The American College of Tax Counsel is composed of senior tax lawyers throughout the United States. Election is by invitation, and to qualify a lawyer must have demonstrated an exceptional degree of professional commitment by active involvement in the organized tax bar, participating in tax seminars, doing significant legal writing or holding important office involving tax administration with the Federal government. Less than 5% of the tax bar in each Federal judicial circuit is eligible. Among the fourteen members of the governing Board of Regents are two former Commissioners of Internal Revenue, a former Chief Counsel for the Internal Revenue Service, and five past or recently elected Chairmen of the Section of Taxation of the American Bar Association.

One of the principal interests of the College is tax policy -- and it is that interest that prompts this statement today.

The Country is crying out for greater equity, and greater simplification, in the Federal tax statutes. This accomplishment will require resolution of many substantive issues. Those involve primarily political decisions. We are not here to take a position on such issues -- our membership includes a broad spectrum of political views -- but we are here to talk about philosophical principles that we think are essential to the achievement of a sound, fair, reasonable tax system.

Historically our Federal tax system has been the envy of the world. The backbone of the system during most of this century has been the income tax. It has succeeded primarily because of the willingness of the great majority of the taxpaying public to report their incomes voluntarily and honestly, accepting that burden as the duty of every loyal American. But as the years have gone on -- particularly since World War II -- the law has become much harder to understand, the ability of the average taxpayer to comply has become far more difficult, and -- whether justified or not -- there has developed a growing opinion that so many others are escaping a fair share of the burden that the duty of a particular taxpayer to file an honest return is not as great as it once was.

We urge that new legislation be designed and written not only to provide a fair and equitable system, but so as to be understood by every taxpayer as providing a fair and equitable system for raising revenue and, thus, insure a high degree of public compliance.

There is increasing evidence that there has been a steady decline in the degree of voluntary compliance with the tax laws. There has been a marked loss of respect for the system. The Internal Revenue Service is sometimes blamed for this loss of respect but we suggest that the Service cannot be expected to administer effectively a law which is almost unadministrable . It should not be surprising that a law filed with abstruse complexities and innumerable variables to fit particular circumstances, will be the source of a constant battle between those, on the one hand, who seek to find ways to avoid unfair consequences or to use such provisions to escape their intended reach, and those on the other, who find it necessary to resort to extreme means to carry out what appears (even somewhat amorphously) to be their intended objective.

To insure understanding that the system is fair and equitable, it should be simple; it should be as uniform as possible, treating similar transactions alike, regardless of whether the taxpayer falls in some group or class having claim to entitlement to some special treatment.

The College believes that the baseline from which a sound income tax system should begin is total net economic income. This should produce a code, the sole purpose of which is to raise revenue.

Over the years the tax base has been increasingly diminished by departing from the concept of total net economic income through enactment of innumerable special classifications, exceptions, conditions and permutations. These are often described as "tax expenditures" because they involve loss (to some degree at least, though not necessarily dollar-by-dollar) of revenues which would have been collected had the tax base been total net economic income. These special classifications and exceptions have produced cries of "unfairness," "abuse," "avoidance," "unwarranted tax sheltering," etc., and unfortunately the response has frequently been enactment of a proliferation of complex, sometimes incomprehensible provisions incapable of being complied with or administered in any rational way. We regret that the tax reform bill recently passed by the House is rife with such complexities and sincerely believe that however meritorious the objectives, they can be accomplished (with little real inequity) in much simpler fashion.

In the area of "tax expenditures," there are three fundamental inquiries.

The first is to determine the extent of the need for public financial support -- the extent to which government financial support should be given to aid or expand certain business or commercial activities or to foster certain social goals.

The second is to determine whether -- even assuming that government support should be provided -- the most effective means of such support is a special provision in the tax law or some other means.

The third consideration concerns the transition from the present system to the new system in areas where a "tax expenditure" is being reduced or removed. It must be recognized that the production of business income has often resulted during recent years from the investment of funds obtained from lenders and other investors who have structured their investments in reliance on "tax expenditure provisions" which directly affect investment yield that market forces dictate. Over the last fifteen years, we have blown hot and cold on industrial stimulation. We have had investment tax credits which were repealed, then reenacted. We have had with ADR what was perceived to be economic life depreciation, but we have changed that to Accelerated Cost Recovery and the debate still rages over the economic effect of both these actions.

Any proposal that eliminates a tax break for which a specific interest group has fought will encounter intense resistance from that group. Arguments for maintaining the status quo will be appealing, particularly as the abrupt change in policy may cause severe economic dislocation. However, we believe that dislocations should not be solved by carving out numerous exceptions. To do so would play havoc with the principles which we believe both the Administration and Congress have agreed as a basis for tax reform, namely that the tax policy be neutral and that it be fair to all. Balancing of equities suggests that these problems be handled by the adoption of transitional rules which would, over a reasonable period of time, alleviate the short term effects of change. However, to the same end, we would urge that these be real transitional rules and not simply delay in affecting repeal of the special classifications and exceptions of present law. We believe that delayed effective dates have too often resulted in repeal of the repealing legislation, and thus wasted the Congress' time. At the same time, it should be understood that we do not advocate imposition of new burdens by retroactive legislation; taxpayers should be free to arrange their affairs on the basis of the law as it is until the Congress makes a final determination of what the law should be for the future. The goal of simplification -- which we believe essential to restore public confidence and make the system workable -- seems to have been almost totally lost in the process.

We also must not lose sight of the basic principle inherent in all tax proposals, i.e., that in order to lower marginal rates for both business and individuals, the base must be broadened. If special exceptions are allowed to continue, the base broadening principle will be defeated.

We believe that now is the time for effective tax reform that will lead to strengthening voluntary assessment and to a general perception that the Internal Revenue Code is fair. In working towards that goal, however, the College recommends that the Congress and the Administration proceed with the objective that the legislation now adopted be total, comprehensive and permanent and that no further significant tax legislation be undertaken for a number of years. The all-too-frequent enactments of recent years -- fifteen major enactments in the last ten years, followed in almost every instance by separate Technical Correction Acts a year or two later -- have not engendered confidence in the system or stability in the economy.*

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* A schedule attached, prepared by Harold I. Apolinsky, a former Chairman of the College, shows that 5,815 subsections of the Code were affected by various Tax Acts over the past ten years and that 4,051 would be changed by the bill recently passed by the House.

The attached Resolution was adopted by the Board of Regents of the College last February stressing the need for a deliberate approach to the development and implementation of tax policy and for greater permanence in whatever is adopted. This Resolution, adopted before fundamental tax reform and simplification became a real possibility, should not be construed as a recommendation against such reform, but rather as a plea that it be done with great care and with expectation of enduring effect. By giving due attention to responsible views at this time, the Congress and the Administration may enact the kind of reform and simplification needed without the requirement of early and frequent changes of significance.

Given the scope of the proposals for basic tax reform and simplification, I should add that we believe it essential that throughout the process the tax writing committees afford opportunities for knowledgeable and responsible elements of society to provide meaningful comments and suggestions. The Congress should take advantage of the ability, experience and judgment of those in the professions and academia who have devoted lifetimes to the study of the theoretical and practical effects of various tax concepts. To the extent the College, or its members, can assist, we will obviously be willing to do so.

In summary, the College respectfully submits that:

(1) Fundamental tax reform, including base broadening and simplification, is a matter of urgency, although the substance

and effective dates will have to be tailored carefully to avoid severe economic dislocation;

(2) Adoption of any significant tax legislation without adequate hearings and opportunity for thorough input would be inappropriate -- considering their scope, and consequence on nearly every one of the various proposals, but this should not present an insurmountable problem in view of the apparent consensus for reform and simplification; and

(3) Even though the income tax system needs drastic reform and simplification, the process should be undertaken in a manner to achieve not only that goal but also stability for a long time to come.

Thank you, Mr. Chairman.

LAW	NO. OF CODE SUBSECTIONS AFFECTED
Tax Reform Act of 1976	1,849
Revenue Act of 1978	664
Economic Recovery Tax Act - 1981	483
Tax Equity and Fiscal Responsibility Act - 1982	530
1984 Deficit Reduction Act	2,245
1984 Retirement Equity Act	44
TOTAL	5,815*

*(3,302 since 1981)

Tax Reform Act of 1969 (major reform after 15 years):	271
The number of Code subsections changed by the proposed Internal Revenue Act of 1985 (H.R. 3838)	4,051

RESOLUTION OF

BOARD OF REGENTS

AMERICAN COLLEGE OF TAX COUNSEL

WHEREAS, The Tax Reform Act of 1976, Revenue Act of 1978, Economic Recovery Tax Act of 1981, Tax Equity and Fiscal Responsibility Act of 1982 and the Deficit Reduction Act of 1984 have substantially affected over 5,000 subsections of the Internal Revenue Code in less than eight years; and

WHEREAS, Frequent enactment of tax legislation of broad scope and substantial complexity adversely impacts upon both the ability of the Internal Revenue Service to monitor compliance and taxpayers' efforts to comply with tax laws, impedes long-term planning of commercial activities, and impedes the orderly development of consistent tax policy; and

WHEREAS, The American College of Tax Counsel has as one of its purposes the development of sound and effective tax policy;

NOW, THEREFORE, Be it resolved that the Regents of the American College of Tax Counsel urge the members of Congress to adopt a more deliberate approach to the development and implementation of tax policy and to foster efficient administration and compliance with the Internal Revenue Code by allowing appropriate intervals bewteen major statutory revisions.

American Foreign Service Association

February 17, 1986

Senator Bob Packwood
Chairman
Committee on Finance
United States Senate
Washington, DC 20510

Dear Mr. Chairman:

We wish to record our strong opposition to any proposal which would rescind the present three-year recovery rule applicable to the taxation of federal retirement annuities. Section 1122(c)(1) of H. R. 3838, the Tax Reform Act of 1985, now before your committee, would impose an immediate tax on retirement annuity payments rather than initially allowing the retiree full recovery, free of tax, of his deposits into the retirement trust fund, on which income tax had already been levied at the time of payment. H. R. 3838 would make this change effective July 1, 1986.

As you know, Mr. Chairman, most individuals begin years in advance to create a personal financial plan to take effect at the time they retire. The tax free recovery of their retirement fund deposits in the months immediately following their retirement is a basic element in such planning. This is especially relevant to the members of the Senior Foreign Service, of whom three out of every four are already eligible for immediate retirement. The men and women of the Senior Foreign Service provide the top-level professional, technical, and managerial expertise which is indispensible to both the short and long-term conduct of our relations with other countries.

Normally, approximately 15% of the Senior Foreign Service retire each year. Present indications are, however, that if the three-year recovery rule is rescinded, this might well result in the immediate retirement of three times that number. Should this occur, it would create a most serious problem in staffing the key positions in our embassies and consulates abroad as well as in the Department of State in Washington.

To avoid precipitating such a situation, we respectfully urge your Committee not to include any provision in its mark-up of the tax reform bill which would eliminate the three-year recovery rule.

Sincerely yours,

Gerald P. Lamberty
Gerald Lamberty
President

2101 E Street NW Washington, DC 20037 (202) 338-4045

Statement

# of the

American Heart Association

on

Tax Simplification

Submitted to the

Senate Finance Committee

February 14, 1986

The American Heart Association on behalf of its two million volunteers nationwide, appreciates the opportunity to submit testimony to the Senate Finance committee on two provisions in their consideration of tax simplification proposals which effect the charities: the charitable contribution deduction for nonitemizers and taxation of health insurance benefits.

We, at the American Heart Association are pleased that the Senate Finance Committee in the true spirit of an open governing process is holding this second round of hearings on tax reform.

We believe that a fair and balanced tax simplification plan will benefit all sectors of the American Society. Fairness will mean itemizers and nonitemizers, and the poor and the rich, will be treated equally. The final outcome will mean the opportunity to share economic prosperity for every man, woman and child in America.

Through generous contributions of the American people, AHA has been able to maintain high standards and ideals. Since 1949, AHA has invested more than $565 million in scientific research and hundreds of millions in updating medical skills that improve patient care, in public education and in community service programs.

AHA has designed programs in the areas of smoking cessation, high blood pressure, nutrition and fitness. These programs are aimed at increasing Americans awareness and knowledge of these heart risk factors and encouraging positive changes in attitudes and beliefs.

The benefits from these cardiovascular research and community education programs are staggering. Since 1968, the adjusted death rates for all cardiovascular diseases declined by 29 percent.

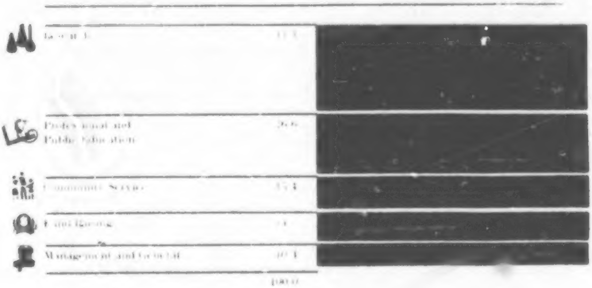
While the trend is encouraging, we must not become complacent. Currently, it is estimated that over 63.29 million Americans have one or more forms of cardiovascular disease. In short, cardiovascular disease continues to be the nation's number one killer.

American Heart Association is committed to basic research that is responsible for advances in medical science. Adequate and continuous support from private tax dollars are essential to ensure that today's scientists make further headway and that a generation of trained researchers carry on this work.

Through tax incentives for charitable giving, and an aggressive fundraising program, the American Heart Association, and its 55 affiliates, have increased revenues for the past five years by an average of 8.9 percent annually.

In 1985, the American Heart Association raised over 140 million in revenues -- up 9.5 percent from 1984. As the following chart indicates, we have used our revenues effectively and efficiently.

1985 Expenditures



The American Heart Association is proud of its accomplishments in research and health prevention and promotion, but we are concerned about maintaining and expanding funding for AHA programs.

The American Heart Association, is pleased that the President, and the United States House of Representatives understand the importance of continuing tax incentives for charitable giving to itemizing taxpayers. However, for the sake of fairness and equity, any tax simplification proposal should also make 100 percent of the nonitemizer deduction permanent.

We believe that reducing tax incentives for nonitemizing taxpayers is unfair to the majority of Americans.

For that reason, AHA is most concerned about two components of the President's tax proposal which could unravel fundamental programs that have dramatically reduced cardiovascular disease in America.

1. Proposals included in the President's tax simplification plan would tax the first $10 of employer contributions for individual insurance benefits, and the first $25 of employee contributions for family health insurance benefits. We, at the American Heart Association are pleased that H.R. 3838 retains current law by allowing employee health insurance benefits to be tax free.

2. House Tax Simplification language included in H.R. 3838 would make thecharitable contribution deduction for nonitemizers permanent with a $100 floor before deductions are allowed.

Currently, 65 percent of the American people are nonitemizers. When tax simplification passes, approximately 80 percent of all Americans will be nonitemizers.

Consequently, tax deductions for charitable giving will be limited to a very small percentage of wealthy Americans.

Limiting the charitable deduction for such a small percentage of Americans could drastically undermine efforts to raise money from lower and middle income Americans.

Currently, non-itemizers give 85 percent of all deductions.

Ninety-nine percent of those who took the deduction for nonitemizers in 1983 had incomes under $50,000 a year. Ninety-one percent had incomes under $30,000.

If nonprofits are to be insured a national base of financial support, any tax simplification plan must include a provision to make the nonitemizing deduction permanent.

Maintaining the nonitemizing deduction retains the true spirit of a fair and equal tax plan -- One hundred percent of all Americans would be eligible to receive a tax deduction for charitable giving not just a select 10 or 15 percent of the population.

Also, it is important to note that the charities are being asked to pick-up the slack from over $15 billion in federal cuts annually for social service and research programs that are traditionally funded by the federal government. With the onset of Gramm-Rudman-Hollings cuts, the need for private donations for research and human service programs for the charities will be further intensified.

Nonprofits have other reasons to be concerned with the $100 floor: When floors on tax deductions are imposed, too often the percentage of the deduction is increased. For example, the three percent floor on medical deductions has been increased to 5 percent. There can be no assurance that there won't be a similar effort to increase the floor on the nonitemizer deduction.

Besides the issue of charitable contribution deductions, the American Heart Association is also concerned about President Reagan's proposal to tax the first $10 of employer contributions for an individual's health insurance benefits, and the first $25 of employee contributions for health insurance benefits. Again, we would like to congratulate the House of Representatives in their foresight in retaining current law which does not tax health insurance benefits.

We, at the American Heart Association, do not support taxation of health benefits. Individuals should be encouraged to purchase health insurance and participate in wellness, nutrition and fitness programs.

To tax health benefits would hurt workers at all income levels, not just higher-paid workers. It would impose a new tax on millions, and would be particularly harmful to low and middle income workers. The very people who need the protection most acutely could not accept lower take home pay, and would choose less protection or be forced to withdraw from these private protection programs altogether. The inevitable result would be a growing national demand for new government programs to fill the gap.

As you know, less comprehensive health insurance tends to have less of an impact on health prevention and promotion activities, and necessary medical intervention.

The first step toward reducing premature death by cardiovascular disease is for the American people to develop proper eating, exercising and nonsmoking habits. Also, people should be encouraged to get medical assistance when it it necessary. Putting off going to the doctor often costs the individual, the government and insurance companies unnecessary dollars, not to mention the added health risk. The old cliche an ounce of prevention is worth a pound of cure is true.

It is essential that revisions of the tax code do not include disincentives for individuals to purchase health insurance.

Also, the tax code must be fair, and benefit all Americans. If all itemizers and nonitemizers receive a tax deduction for charitable giving, all sectors of society will benefit. The Congress cannot allow current charitable contribution deductions to be dropped. It does not make sense. It gives 10 to 15 percent of all taxpayers a tax advantage that 85 to 90 percent of all taxpayers will not receive.

Elimination of the charitable giving coupled with Federal budget cuts, reduction or elimination of certain charitable contributions would mean a national decline in community service and research programs.

In conclusion, Oliver Wendell Holmes once said, "When you pay taxes you buy civilization," but we have to ask ourselves what kind of civilization will we be buying with a tax policy that limits charitable contributions deductions, and taxes health benefits? Will it be a civilization in which the poor and average working American cannot afford health insurance? Will it be a civilization in which our traditions for volunteerism and charitable activities will be unable to meet the needs of our communities?

Dick [illegible]
393-5060

HOUSE COMMITTEE ON SCIENCE

AND TECHNOLOGY

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[illegible]	Robert A. Roe (NJ) Allen Freedman	2243	Follow Brown lead	5751	Allen Freedman
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	Timothy E. Wirth (CO) [illegible]	2262	ok B	2161	
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	Harry M. Reid (NV) - Steve [illegible]	1530	position of leadership	5965	
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	Richard Stallings (ID) [illegible]	1233	left message	5531	
	Bart Gordon (TN) [illegible]	1517	message [illegible] before 11:00	4231	
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2. Reduce the age of the advisory committee

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Steve Cremonese - [illegible]

American Hospital Association

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STATEMENT OF THE AMERICAN HOSPITAL ASSOCIATION
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
ON
THE IMPACT OF COMPREHENSIVE TAX REFORM ON NONPROFIT HOSPITALS

FEBRUARY 18, 1986

SUMMARY

The American Hospital Association strongly opposes the provisions of H.R. 3838, the Tax Reform Act of 1985, that would severely restrict the use of tax-exempt financing for nonprofit hospitals, and drastically change the status of deferred compensation plans used by nonprofit, tax-exempt health care institutions. This statement supplements my statement before the Committee during hearings in July of 1985.

Hospitals serve a critical public purpose by providing high quality health care services to their communities, often at no charge to the indigent. Hospitals also serve society through their educational and research activities.

The ability of hospitals to continue to provide high quality medical care depends heavily upon success at capital formation. Capital projects are primarily undertaken for modernization and restructuring of outstanding debt, keeping facilities in compliance with life and safety codes, and financing the purchase of sophisticated medical equipment.

If the Tax Reform Act of 1985 is enacted as passed by the House, many nonprofit hospitals would be denied access to capital markets and the cost of capital used to modernize, renovate, and upgrade these institutions would increase dramatically because they would be forced to turn to taxable markets. In addition, the ability of nonprofit tax-exempt hospitals to attract and retain top personnel would be diminished in relation to private institutions because of limits that would be placed on their deferred compensation plans.

INTRODUCTION

Nonprofit health facilities provide essential public purpose medical services and have traditionally been the mainstay of our nation's health care system--58 percent of the nation's community hospitals are nongovernmetal, nonprofits. These institutions are created, supported, and directed by communities to supplement the public hospital system that exists to meet state and local governments' basic responsibility for ensuring public health. They provide 70 percent of all community hospital beds and deliver high quality health care to a large proportion of Medicare, Medicaid, and indigent patients. They provide the vast majority of socially desirable but unremunerative medical services, including medical education and research, neonatal care, open heart surgery and cardiac care, organ transplants, burn care, and pediatric intensive care.

Capital is necessarily vital if private, nonprofit hospitals are to advance public health policies. Capital is needed for renovation and replacement of large numbers of facilities constructed after World War II, generally in our older urban centers, and now at the end of their useful lives. Likewise, capital is needed for modernization to employ new life-saving technologies; creation of more efficient health care delivery facilities such as ambulatory care centers and nursing homes; and new or expanded facilities, generally in the sun belt where population is increasing (this represents less than 40 percent of hospital bond issues). At the same time, costs of modern medical equipment and hospital construction continue to increase.

IMPACT OF H.R. 3838 ON TAX-EXEMPT FINANCING

VOLUME LIMITS

As passed by the House, H.R. 3838 would effectively limit the issuance of tax-exempt bonds for 501(c)(3) organizations to about one-half of the issuance of such bonds in 1984. Tax-exempt bonds for nonprofit health care facilities should not be subject to the volume limitations imposed by the House bill.

Because the limits are based on population on a state-by-state basis, some states would be more adversely affected than the average, particularly where many older hospitals are now in desperate need of renovation or where population influxes have created the need for new facilities. A per capita measure for tax-exempt bond issuance is particularly inappropriate for health care facilities because much of their capital needs are not a function of current population levels.

Tax-exempt bonds provide the primary source of capital for nonprofit health care facilities because other sources are increasingly unavailable. Over 75 percent of all major hospital construction projects are debt financed, and 80 percent of these are financed with tax-exempt bonds. Other sources of public funding have been terminated (in the case of the Hill-Burton program of grants, low interest loans, and loan guarantees for hospital construction), or substantially reduced (in the case of Medicare and Medicaid reimbursement). Charitable contributions are a small and decreasing percentage of hospital capital. Many nonprofit hospitals would have no access to the taxable bond market because of their inability to meet the higher debt service costs of taxable debt.

Other policy changes would create more demand for hospital capital but reduce their ability to raise and repay it. Proposed further reductions in federal health care, operating, and capital reimbursement payments will require new investment in more efficient health care delivery facilities. Proposed reductions in Medicare capital payments to hospitals, estimated between $5 billion and $13 billion over the next five years, are based on interest payments at tax-exempt rates. Financially weaker institutions would be unable to raise funds in the taxable market if their access is blocked to the tax-exempt market. Stronger institutions able to issue taxable debt would have higher debt service costs and would either have to raise their rates or divert funds from patient care services to debt service payments.

OTHER RESTRICTIONS

Under the House bill, hospitals would be unable to advance refund to reduce interest costs or remove covenants that prevent appropriate reorganizational responses to changes in the health care system, especially due to federal policy changes, that were not contemplated when the bonds were issued.

Nonprofit health care facilities must be able to advance refund on the same basis as governmental entities because hospitals need the mechanism to comply with changes in federal health policy. Federal reimbursement changes and cost cutting measures require that hospitals advance refund when interest rates decline in order to reduce their debt service costs. They also require that hospitals be able to change restrictive covenants that would preclude the establishment of more efficient health care delivery facilities such as ambulatory care centers and clinics or preclude mergers and acquisitions to form more efficient multi-hospital systems.

The definition of advance refunding should be revised to extend the proposed period between issuance of the refunding bonds and the redemption of the refunded bonds from 30 to at least 90 days (current law provides 180 days between issuance and redemption). This is necessary because it is impossible to refund and redeem in 30 days due to the 30-to-60 day notice requirement.

The volume of advance refunding should not count against any volume limitation because new issues will generally take precedence, effectively eliminating advance refunding authority. The requirement that the refunded bonds be redeemed as soon as possible should be deleted because it would prohibit all low-to-high refundings to remove restrictive covenants. This is because redemption before the maturity date of the refunded bonds would be prohibitively expensive.

The House bill requirement that five percent of bond proceeds be spent within 30 days should be extended to at least six months because it is not possible to prudently spend five percent of the very large sums involved in major hospital construction projects (up to $500 million) in that short period of time. In addition, issuance costs should be included as an expenditure towards the fivo percent.

The requirement that all proceeds be spent in three years should also be deleted. Issuers and bond counsel cannot guarantee that unforseen construction delays and projects that typically take three years will not preclude compliance with this requirement. Meeting this requirement is totally beyond the control of the issuer.

The arbitrage restrictions proposed in the House bill would increase the volume of bond issuance, increase debt service costs, and divert funds from patient care services to debt services. Although the AHA opposes restrictions on this important financing tool, if it is necessary to impose restrictions, then at least the proposed rules should be revised to eliminate provisions that increase administrative costs of issuers and hospitals with little or no increase in federal revenues. Accordingly, the temporary period for construction should be extended to six months for single issues and 12 months for pools. The temporary period for construction should be extended to five years to account for large multi-phase projects, and acquisitions occurring in conjunction with construction projects should be subject to the same rules as the construction project.

IMPACT OF H.R. 3838 ON EMPLOYEE RETIREMENT PROGRAMS

As passed by the House, H.R. 3838 would apply the limitations and restrictions applicable to eligible and ineligible unfunded deferred compensation plans of State and local governments to unfunded deferred compensation plans maintained by private, tax-exempt organizations. This provision drastically changes the status of deferred compensation plans of many private, nonprofit hospitals.

The imposition of restrictions on deferral arrangements maintained by 501(c)(3) hospitals would unjustifiably discriminate against these hospitals in relation to their private counterparts because the latter could continue to offer deferral arrangements without the restrictions proposed in H.R. 3838. This important retirement tool, currently used to attract and retain key personnel, would be denied to nonprofit hospitals and permitted for private hospitals.

Deferred compensation plans are an attractive benefit to top executives and professionals and an effective cost reduction device for their employers. Hospitals benefit because many top professionals will accept lower salaries if coupled with a deferred compensation plan. These plans allow nonprofit organizations to stretch limited salary budgets to attract top personnel who might otherwise not be available.

Most nonprofit hospitals lack the resources to compete with corporations and government for top talent. To aggravate the problem, private and public sector organizations have ready access to deferred compensation plans, but nonprofits would not have the same access under H.R. 3838.

The proposed change does not allow the participants in retirement plans to avoid taxation. The deferral today of otherwise taxable wages or fees in no way avoids taxation; deferred dollars will be fully taxable when received. In fact, both principle and and interest are both taxable as ordinary income when they are ultimately received by a plan participant.

CONCLUSION

The nation's nonprofit hospitals as well as their access to capital have been firmly supported both by public policy and private giving. The President's proposal for comprehensive tax reform and the House-passed Tax Reform Act of 1985, contradict this historical commitment and fail to recognize the practical realities of both the current health care marketplace and the problems confronting nonprofit hospitals in taxable corporate debt markets.

Neither the federal government nor the public would be well served by hindering the ability of nonprofit hospitals to maintain and upgrade their facilities adequately so that access to health care may be ensured. The revenue realized by the elimination or restriction of tax-exempt bonds for nonprofit hospitals would be insignificant in comparison to the costs that inevitably would result from failure to maintain the nation's hospital infrastructure.

Most importantly, the private, nonprofit hospital sector, which meets a majority of this nation's hospital care needs, is made up of institutions serving a public purpose in their communities. Thus, facilitating access to tax-exempt financing is an appropriate and positive tax policy.

Similarly, restricting the ability of private, nonprofit hospitals to attract and retain top personnel will put them at a disadvantage with their private sector counterparts. The restrictions on deferred compensation proposed by the House-passed Tax Reform Act of 1985 will put private, nonprofit hospitals at a competitive disadvantage. In order to meet the challenge of the private sector for such talent, the tax-exempt hospitals must be legally permitted to offer as many benefits as are offered by the private sector.

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ahca
American Health Care Association 1200 15th Street, Washington, DC 20005 (202) 833-2050

February 5, 1986

The Honorable Robert Packwood
Chairman, Senate Finance Committee
SD-221 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Packwood:

The American Health Care Association is the largest organization of nursing homes, representing more than 8000 non-profit, proprietary, and governmental facilities throughout the United States. Our member facilities provide long term care services to more than 300,000 of our nation's elderly and disabled.

We are writing you concerning the Finance Committee's hearings on federal tax reform and request that this letter and the attachment be incorporated into the hearing record. AHCA believes federal tax reform is long overdue and necessary if we are to bring simplicity, fairness, and proper economic incentives back into our federal tax code. We also believe tax reform should be integral to and instrumental in reshaping the health care delivery system in the United States, to make it more effective in dealing with the catastrophic costs associated with chronic illness, especially for our elderly.

We have concerns, however, with the House tax reform bill (H.R. 3838) and want to bring to your attention several proposals which we believe will impact both the delivery of care to the residents of nursing homes and the ability of the long term care industry to meet future needs of the elderly and infirm.

How to pay for long term health care and capital formation are by far the most critical issues facing the nursing home industry over the next two decades. We recognize that many elderly face impoverishment paying for nursing home care and that the demand for long term care services already far exceeds the capacity of nursing homes to provide such services. Future demographic trends will only exacerbate this capacity shortage unless adequate capital formation can be attracted into the nursing home industry.

Tax laws can and should be utilized to address the long term care health needs of elderly Americans by both encouraging the accumulation of private financial resources to pay for such services and creating a favorable investment climate for needed capital formation in the long term care industry.

Utilizing the tax code to encourage accumulation of private resources will relieve the unrelenting pressure on public health programs that currently bear the burden for nursing home care. The development of private long term care insurance and fostering of other private financing options should be aggressively pursued through the tax code. Federal tax incentives should be implemented so individuals and families are encouraged to accumulate personal savings

A non-profit organization of proprietary and non-proprietary long term health care facilities dedicated to improving health care of the convalescent and chronically ill of all ages. An equal opportunity employer.

and purchase private long term care insurance. Specifically, tax reform should eliminate current IRA age distribution requirements, develop health care IRA legislation and enact tax incentives for the development and purchase of long term care insurance protection.

Concerning capital formation, AHCA offers the following recommendations which are intended to create a more favorable environment for private capital investment.

Restrictions on tax-exempt bond financing because of the extension of the overall statewide limitations to all private purpose obligations will have a serious impact on the nursing home industry. Not only will the sources of capital become more competitive, but the cost of capital may increase as well. Because tax-exempt bond financing is so critical to nursing homes, AHCA recommends that not only should tax-exempt financing (including small issue IDBs) be retained for nursing homes but recognition should be given to the public purpose of these facilities by including all nursing homes and other long term care facilities in a separate per capita set-aside as is being proposed under the House bill exclusively for non-profit organizations.

Elimination of the investment tax credit is one of the largest revenue items in the Administration's tax reform proposal and will have a particularly significant impact on capital-intensive industries like the nursing home industry. Repeal of the credit will significantly alter operational cash flows and make new construction, expansion, the purchase of furniture, equipment, or other tangible property that much more unattractive. Loss of these significant tax credits will require a restructuring of nursing homes working capital needs and, as a result, place increased emphasis on operational revenues to justify capital expansion and renovation decisions at a time when such revenues are facing further constraints by public programs such as Medicare and Medicaid. AHCA recommends retention of the investment tax credit for capital intensive health care providers such as nursing homes or, the implementation of a corresponding reduction in corporate and individual effective tax rates to negate the loss of the credit.

Depreciation rules, as proposed by the House bill, will have less generous asset depreciable lives than the current accelerated cost recovery system (ACRS). AHCA recommends that the depreciable life for real property be retained as under the current ACRS methodology, and not increased to 30 years as proposed under the House bill.

AHCA agrees with the House provision that the at-risk limitation rules should not be extended to real estate acquired on or after January 1, 1986. Currently, the ability of nursing homes to use partnerships to increase private capital funding sources has relied on the use of limited partnership and non-recourse financing arrangements. Any requirement for full recourse financing arrangements in order to obtain loss recognition for partners will greatly diminish this significant source for private capital investment for nursing homes.

Senator Robert Packwood
February 5, 1986
Page Three

Finally, the Targeted Jobs Tax Credit (TJTC), expired at the end of 1985. AHCA recommends it be reinstated. The TJTC, which applied to wages paid to eligible employees who began work on or before December 31, 1985, was available to employers for hiring various targeted groups of less fortunate individuals. According to a recent Congressional Research Service analysis of the targeted job tax credit program, the program has been cost effective. Furthermore, the TJTC is as important as the investment tax credit for the nursing home industry. In 1982, the industry claimed more than $6.8 million in job tax credits. Since labor accounts for approximately 60 percent of a nursing home's total costs, elimination of this credit will have a detrimental effect on the ability of nursing homes to supplement their labor force with cost effective but dedicated employees at a time when federal and state Medicaid funding is becoming increasingly constrained. AHCA strongly encourages the retention of the TJTC.

A more detailed explanation on AHCA federal tax reform recommendation is attached for further information. I hope to discuss these and other issues with your committee as you continue to consider tax reform this year.

Sincerely,

William Hermelin
Vice President
Congressional Affairs

WH:TJ/jbe
8679.02

Attachments

AMERICAN HEALTH CARE ASSOCIATION

Position Paper
on
Federal Tax Reform

AHCA believes federal tax reform is long overdue and necessary if simplicity, fairness, and proper economic incentives are to be brought back into our tax code. AHCA further believes that appropriate tax reform can also become an instrumental public policy designed to increase private initiatives to meet the long term health care needs of an increasing elderly American population.

How to pay for long term health care and the capital formation needs of long term care providers are by far the single most critical issues facing the nursing home industry for the next two decades. We already recognize that many victims of catastrophic illness or chronic disease face eventual impoverishment in paying for needed health care services. The only viable current alternative is a reluctant and devastating dependency on public assistance programs like Medicaid. Demand for long term care services already far exceeds the capacity of nursing homes to provide such services and future demographic trends will only exacerbate this capacity shortage unless adequate capital formation can be attracted into the nursing home industry.

Lack of private long term care health insurance and limited financing options to pay for long term care needs have all led to an inordinate dependency on public assistance programs. Greater capital financing costs and increasing constraints on Medicare and Medicaid reimbursements have all contributed to adversely affect economical capital formation for nursing homes. Combined, these two dilemmas pose serious problems to our health care delivery system at a time when health care needs of our elderly should be a national priority.

Tax laws can and should address the long term health care needs of elderly Americans by:

- encouraging the accumulation of private financial resources to pay for such services, while
- creating a favorable investment climate for needed capital formation in the long term health care industry.

In addition, federal tax reform should retain special tax incentives (Targeted Jobs Tax Credit) encouraging employment opportunities for certain targeted individuals which will assist and enable the health care industry to maintain and attract a needed labor force.

I. The Need for Nursing Home Services: Current and Future

Nursing homes shoulder a heavy public responsibility of providing health care and housing services to our nation's frail elderly and disabled. There are approximately 13,300 nursing homes certified under Medicare or Medicaid providing more than 1.3 million skilled or intermediate care beds to the neediest and most vulnerable of populations.

Residents of nursing homes require a wide variety of medical and social services. All require health care treatment, ranging from complex to routine. A recent Maryland Task Force report on Alzheimer's Disease and Related Disorders, citing a epidemiological study done by Johns Hopkins University and Medical School, indicates that upwards of 60-70 percent of all residents in nursing homes may be victims of the tragic Alzheimer's Disease or other related disorders. In addition, national health care data indicates that approximately eighteen percent of nursing home residents have ambulatory problems. Twenty-two percent of residents require full assistance in eating. Forty-eight percent are incontinent.

There is also an extremely high level of dependency by residents on public assistance programs to help pay for nursing home services. More than 2 out of every 3 resident of nursing homes are on Medicaid. Medicaid is by far the single largest public payor for nursing home services. Approximately 45 percent of all nursing home expenditures are financed with Medicaid program assistance, approximately 2 percent from Medicare and another 4 percent from all other federal programs such as the Veterans Administration.

During the next two decades, a profound change will occur in the makeup of the U.S. that will significantly increase the need for long term care services. By the year 2000, 13.1 percent of American citizens will be over 65. Six-and-one-half percent will be over 75. Alone, these statistics may not seem significant. However, what is significant are projections showing that in a mere 15 years the 75-84 age group will increase from 7.7 to 12.2 million, while the 85 and over population will more than double -- from 2.2 to 5.1 million. It is anticipated that 1 out of 5 individuals over age 75 will need nursing home care.

Statistics also show that the rate of nursing home use increases dramatically with age: for individuals over 85, the utilization rate is 23 percent; for the 75-84 age group, the rate is six percent; for the 65-74 population, utilization is two percent. These rates are closely tied to the fact that older seniors are prone to chronic illness and therefore have greater need for supportive services. Trends show and studies confirm that as the population ages, the need for long term care increases. Independent researchers have also documented that an additional 1.2 million nursing home beds will be needed by the year 2000 just to maintain the present age-specific level of service. In practical terms, a 120-bed nursing home would need to open each day through 2000 just to meet the projected demand for care. The cost of these beds is projected to exceed $60 billion.

II. Paying for Long Term Health Care

Tax laws can become an effective and powerful tool to encourage the accumulation of private financial resources needed to pay for long term health care services and accordingly, lessen dependence on public assistance programs like Medicaid. A recent study by the Harvard Medical School cited by the House Select Committee on Aging concluded that in a sample of elderly 66 years of age and older and who live alone, two-thirds would risk impoverishment (and require public assistance) by the 13th week of entering a nursing home. As a means of controlling increasing public expenditure levels on long term care, various federal tax incentives should be utilized to prompt the development of adequate private financing options, including the development of private long term care insurance.

AHCA believes the following federal tax incentives are necessary towards encouraging the development of private financing options for long term health care needs:

- substantial tax credits for individuals who purchase private long term care insurance and corresponding incentives to insurance companies such as accelerated amortization of research and development expenditures and special taxation for premium advances, premium income, and loss reserves for long term care insurance products.

- strengthening of current Individual Retirement Account (IRA) provisions to allow for continued corpus accumulation after age 70 1/2 and elimination of the current distribution requirements at such age.

- creation of incentives for developing health care IRA's such as the legislative proposal introduced by Congressman Slaughter of Virginia (H.R. 3505) and the concept of individual medical accounts (IMAs) as proposed by the Secretary for Health and Human Services (Otis R. Bowen, M.D.).

- elimination of current federal tax disincentives to family caregivers or financial supporters under the dependency exemption requirements (Code Sections 151 and 152) and the enabling provisions for dependent care credits (Code Section 44A).

III. Capital Formation Incentives for Long Term Care Providers

Using a cost base of $25,000 per bed and an annual inflation rate of 6 percent, a $60 billion capital investment would be needed to maintain current service capacity. In addition, because more than 70 percent of all nursing homes are at least 20-years old, this price tag is probably significantly higher when renovation needs are projected.

At a time when the number of dependent elderly is increasing, the ratio of nursing home beds to aged population is decreasing. Nursing homes currently are having difficulty attracting economical private capital investment. Several states, under the pressure of budgetary shortfalls, have constrained Medicaid reimbursement, restricted certificate of need, imposed building moratoriums, and created a fiscal climate that raises apprehension in the investment community over capital funding for nursing homes. When available, investment capital is usually at more expensive financing rates because of risk premiums associated with nursing home investments. AHCA believes that federal tax policies should create a favorable investment climate for needed capital formation in the long term care industry, or at least one that is neutral to the above capital constraints, if the elderly are to continue having access to LTC services.

AHCA recommends that federal tax reform include the following capital formation provisions:

- retention of tax-exempt bond financing, including small issue industrial development bonds (IDBs) for nursing homes,
- lower effective tax rates or retention of the investment tax credit,
- continuation of accelerated depreciation provisions for real property assets,
- retention of current real estate exclusion from partnership "at risk" rules.

A. Tax Exempt Bond Financing

Tax-exempt bond financing is critical to meet the capital formation needs of nursing homes and should be retained. Section 501(c)(3) non-profit nursing homes using tax-exempt entity bonds and proprietary nursing homes using small issue IDBs will retain access to tax-exempt bond financing under the House tax reform proposal (H.R. 3838), but that access will become more competitive and limited.

House bill 3838 requires all non-governmental tax-exempt bonds to be annually limited in the aggregate to no more than the greater of $200 million or $175 per resident ($125 after 1987). A separate $25 per resident set-aside is reserved for non-profit organization projects leaving only a maximum $150 per resident limitation on all other bond financed projects.

In addition, small issue IDBs will be limited not only by the $200 million/$175 per resident limitation but also by the existing $40 million per user ceiling imposed under the 1984 Tax Reform Act.

AHCA believes that these overall limitations will lessen the availability of tax-exempt bond financing for nursing homes. That use will adversely affect the nursing home industry and possibly the availability of long term care services to our elderly. Not only will the sources of capital become more competitive, but the cost of capital will increase as well.

The federal government directly benefits from the use of tax-exempt financing by nursing homes. The resultant reduction in nursing home capital financing costs in conjunction with the restrictions on use of accelerated depreciation result in lower operating costs, thus increased net operating income and greater treasury tax revenues. In addition, Medicare and Medicaid pay less through lower reimbursement levels for capital costs. And probably most important in terms of fiscal savings, the potential to save significant dollars in added and inappropriate expenditures for patients backed-up in hospitals awaiting nursing home placement is directly proportional to the availability of nursing home beds. The General Accounting Office has estimated that Medicare and Medicaid annually pay for up to 9.2 million days of inpatient hospital care on behalf of patients who only require a level of care that could appropriately be provided in a nursing home. Since these inappropriate costs are already built into our acute care system, added costs are being incurred by both Medicare and Medicaid, as well as other third party payors for such inappropriate services. The capacity of the nursing home industry to accommodate the inappropriately placed patients can significantly reduce overall expenditures on health care services.

Much of the discussion in the House Ways and Means Committee over retention of tax-exempt bond financing was directed towards the needs of hospitals and acute care, but little, if any, discussion was directed at the need for long term care services. It was for this reason that the Committee not only retained tax-exempt financing for non-profit organizations, but created a separate $25 per capita set-aside provision as well.

AHCA applauds the Committee's limited recognition of capital needs for health care providers but believes the criteria for determination of tax-exempt bond financing should be public purpose usage, not organizational sponsorship. More than two out of every three residents of nursing homes are dependent upon the Medicaid public assistance program to help pay for their care needs. Thus, nursing homes, both non-profit and proprietary facilities alike, already serve a significant public purpose in providing long term care services to the neediest of populations and thus should be included in the $25 per capita set-aside proposed for non-profit organizations. In addition, the $25 per capita set-aside should be increased accordingly.

In addition, to make tax-exempt financing even more unattractive, the House adopted a corollary provision recommended earlier in the President's tax proposal, to deny a favorable interest deduction for banks, thrifts and other financial institutions carrying tax-exempt obligations. Currently, these institutions receive an 80 percent deduction for interest expense incurred to carry or purchase tax-exempt obligations. This deduction has been a significant incentive for financial institutions to carry tax-exempt obligations. The House bill will eliminate this interest deduction for financial institutions acquiring tax-exempt obligations after December 31, 1985, and thus, will probably have a dampening effect on the availability of tax-exempt bonds.

As a corollary recommendation, AHCA urges that the current favorable tax treatment afforded financial institutions to carry public purpose tax-exempt obligations should also be retained to encourage their continued participation in carrying such obligations.

B. Elimination of the Investment Tax Credit

This is one of the largest revenue items in the House tax reform proposal and will have a particularly significant impact on capital-intensive industries like the nursing home industry.

Repeal of the credit will significantly alter operational cash flows and make new construction, expansion, the purchase of furniture, equipment, or other tangible property that much more unattractive. Loss of these significant tax credits will require a restructuring of nursing homes working capital needs and, as a result, place increased emphasis on operational revenues to justify capital expansion and recapitalization expenditure decisions at a time when such revenues are facing further constraints by public programs such as Medicare and Medicaid. AHCA recommends retention of the investment tax credit for capital intensive health care providers such as nursing homes or a corresponding reduction in effective corporate and individual income tax rates in order to neutralize the significant loss of the credit.

C. Depreciation

The House tax reform bill will repeal the current accelerated cost recovery system (ACRS) and replace it with a less generous depreciation system, one that will generally lengthen the period of time over which a business asset can be written off. Specifically, the proposed depreciation system will allow business assets to be classified into one of ten classes and depreciated over periods ranging from three to 30 years depending upon the asset classification.

The House bill, while lengthening depreciation periods, will offer a unique provision enabling depreciable assets to be partially indexed, beginning in 1988, to offset some of the impact of inflation. According to the bill, if inflation exceeds 5 percent, 50 percent of the inflation above 5 percent will reflect in the asset valuation basis for depreciation. This provision will allow partial but reasonable tax relief, through higher depreciation allowances, during periods of excessive or chronic inflation above 5 percent.

Nursing homes however, require a significant real property investment and it is real property that will be most adversely affected under the House method because with the depreciation recovery period will be significantly lengthened from 15-19 years to 30 years and the straight line method of depreciation will be the only allowable method used to calculate annual depreciation allowances. Thus, real property assets will be written off at a much slower pace than currently allowed under the ACRS method.

AHCA believes that capital investment in long term care facilities should be encouraged and that depreciation guidelines should accordingly reflect this encouragement. A thirty year recovery period is too extended for capital formation and replacement of nursing homes.

D. Partnership At-Risk Rules

AHCA believes that the decision by the House in H.R. 3838 to continue the real property exclusion from the partnership at-risk limitation rules was proper and reasonable. Earlier, the Administration had proposed to extend the at-risk limitation rules to real estate acquired on or after January 1, 1986, thereby limiting partnership losses to the amount the taxpayer has at-risk with respect to an investment. Currently, the ability of nursing homes to use partnerships to increase private capital funding sources has relied on the use of limited partnership and non-recourse financing arrangements. Requiring full recourse financing arrangements to obtain full loss recognition for partners in real estate partnerships could adversely affect the nursing home industry's ability to acquire needed private capital investment, especially given the risk perception associated with the fiscal uncertainties of state and federally sponsored public assistance programs like Medicaid.

IV. Targeted Jobs Tax Credit

The targeted jobs tax credit (TJTC) expired at the end of 1985 but the House bill proposed to extend the credit for an additional two years. Under the bill, the credit would be available to employers for wages paid to eligible individuals who begin work on or before December 31, 1987. The bill would modify the previous credit by reducing the 50 percent credit for first year wages to 40 percent and eliminating the 25 percent credit for second year wages. In addition, the bill requires that individuals must be employed for no less than 14 days to be eligible for the credit.

AHCA believes that the TJTC is an important tax provision for the nursing home industry and accordingly urges that it be reinstated. According to 1982 U.S. Treasury Department data on corporations, nursing homes claimed more than $6.8 million in jobs tax credits. Since labor costs represent approximately 60 percent of a nursing home's total costs, elimination of the credit would have a detrimental effect on the ability of nursing homes to maintain and attract a needed labor force at a time when Medicare and Medicaid funding for health care services is becoming increasingly constrained.

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American Institute of Merchant Shipping

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February 18, 1986

The Honorable Bob Packwood
Chairman
Senate Committee on Finance
SD-219
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

The American Institute of Merchant Shipping (AIMS) would respectfully request that these comments be included in the record of testimony for H.R. 3838, the House passed Tax Revision Bill.

The American Institute of Merchant Shipping (AIMS) is a national trade association representing 22 U.S.-flag shipping companies which own or operate approximately nine million deadweight tons of tankers, dry bulk carriers, container vessels, and other oceangoing vessels engaged in the domestic and international commerce of the United States.

AIMS is deeply concerned with the devastating negative impact the tax changes, contained in the President's tax reform proposals and, to a somewhat lesser degree in H.R. 3838, would have on the maritime industry. Our concerns are shared by the vast majority of the maritime industry, and I am sure by many members of both Houses of Congress. Our remarks will not be new and startling, rather they will be a restatement of fundamental truths which, in our opinion, inexorably lead one to the conclusion that the CCF Program, as well as the Accelerated Cost Recovery Schedules (ACRS), should not be changed as they are viable economic methods of supporting a U.S. Merchant Marine capable of safeguarding our nation's commercial and security/defense interests.

If we are to reverse the current unhealthy trend and revitalize the U.S. maritime industry, the United States must maintain policies comparable to those of the rest of the world. We must create a climate in which American-flag ships can compete fairly and on a par with their foreign competitors. As part of such a policy to stimulate the U.S. Merchant Marine, we should include a competitive environment which encourages capital formation and investment.

If our U.S.-flag maritime industry is to compete with their foreign counterparts on an equal basis, our tax environment must reflect substantially the same benefits as theirs. All major maritime nations provide tax environments much more conducive to shipping than does the United States and favorable capital formation is an essential component of their environments.

The President's tax reform proposal proposes to do away with the Capital Construction Fund (CCF) Program as set forth in section 607 on the Merchant Marine Act of 1936. The CCF Program has been one of the most successful federal maritime promotion programs ever conceived. Since the fund was established in 1970, it has been a major factor in assisting the maritime industry in accumulating capital for the construction, reconstruction or conversion of a wide variety of marine vessels.

The CCF is but one of a number of interlocking and complementary maritime programs designed to help the maritime industry reach the goal of "adequacy" as defined in the Merchant Marine Act of 1936, as amended. CCF is a maritime policy issue--not a tax issue, as witnessed by the fact it is not in the Internal Revenue code, and should be evaluated as such. AIMS endorses retention of the CCF Program as it is presently constituted but could support those changes contained in the House passed bill.

The capital recovery/formation modifications proposed in the Treasury Department's proposed changes in the tax code, and H.R. 3838, i.e. elimination of the investment tax credit and the extension of the depreciable life of vessels, would return the U.S.-flag operator to the status of the significant capital recovery disadvantage that existed prior to 1981. The Treasury Department's proposal would extend the depreciation life of a vessel from the five years under current law to ten years. The House tax reform bill would replace the ACRS with the Incentive Depreciation System (IDS). Under IDS, assets would be grouped into classes based on class lives assigned under the Asset Depreciation Range (ADR) system. Vessels are assigned to class 6, with the cost of a vessel recoverable over a sixteen year period. The only offset to the maritime industry for tax increases proposed by the Administration and in H.R. 3838 would be a reduction in the corporate tax rate from 46% to 36% on earned income.

Because operating earnings for U.S. operators are at best low and will continue to be highly depressed for the foreseeable future a reduction in the corporate tax rate is symbolic at best and does little or nothing to offset the impact of the negative changes presently under consideration. Under those conditions, the ability of shipowners to replace inefficient vessels with modern units and/or to increase their fleets will be next to impossible. As a consequence, a cornerstone of our national security planning, namely, that merchant vessels will be available as military auxiliaries in time of national emergency as a low cost by-product of our commercial shipping activities will be destroyed.

A classic example of the possible effect on national security of a increase in the depreciation schedule for shipping is the case of vessels solely operating between U.S. ports. The "Jones Act Fleet", as these vessels are referred to, is comprised largely of tankers used to transport domestic crude oil to refineries and refined products to market. Nearly the entire supply of militarily useful commercial tankers available to serve the needs of the military in a national emergency are the vessels that operate under the protection of the Jones Act. However, if serious disincentives to invest, such as alterations to the ACRS, were to become law it is highly unlikely that commercial operators could afford to invest in the large number of replacement vessels needed to provide the underpinning of our national security shipping inventory. The national defense planning which presumes that the Jones Act will continue to supply a large part of the required inventory of militarily-useful tank vessels becomes erroneous.

It is considerably more cost effective for the U.S. government to maintain its sea-lift base through tax incentives to the private sector than for the Department of Defense to fund the full cost of construction and maintenance of the nation's sealift assets. This fact cannot be emphasized enough - sealift is a necessary part of an effective national defense and it must be made available to our defense establishment either indirectly from the privately owned commercial fleet or directly by a government owned fleet. The USSR has opted for the latter and by default or neglect in failing to provide modest incentives to our commercial fleet we may be forced down the same path.

AIMS is also concerned with the national security implications of proposed changes contained in the House bill that would repeal the shipping reinvestment provisions of Subpart F of the tax code even if those earnings are reinvested in shipping assets. We believe this proposal could have a disastrous effect on the Effective U.S. Controlled Fleet (EUSCF) which is counted on to maintain the commercial viability of the United States while U.S.-flag vessels are called on for delivery of fuel and supplies to the crisis area.

Proponents of Subpart F changes claim that the funds now invested in foreign flag shipping would be invested in U.S. flag shipping. That is shear nonsense and not one more ton of U.S. flag shipping would spring from that change. In fact the United States would be a loser all around -- no additional U.S. flag ships and a steady erosion of our EUSCF.

The resulting loss of vessels under American ownership could damage our national security without generating a significant amount of tax revenues ($10 million per year) to the Treasury or bringing any additional vessels under the U.S.-flag. For this reason AIMS would urge the retention of Subpart F in it current form.

AIMS would again like to thank you for the opportunity to testify on this important legislation.

Very truly yours,

Thomas J. Lengyel
President

WRITTEN STATEMENT
ON BEHALF OF
THE AMERICAN INSURANCE ASSOCIATION
AND
THE AMERICAN COUNCIL OF LIFE INSURANCE

FEBRUARY 21, 1986

This statement is submitted on behalf of the American Insurance Association and the American Council of Life Insurance concerning the impact on U.S. insurance companies that would flow from the changes H.R. 3838 (the proposed Tax Reform Act of 1985) would make in the rules of the Internal Revenue Code governing or affecting the foreign operations of U.S. insurers. It is offered for inclusion in the record of the Committee's hearing on H.R. 3838.

The American Insurance Association is a trade association representing approximately 174 Property and Casualty insurance companies nationwide. The American Council of Life Insurance is a trade association representing approximately 630 Life insurance companies nationwide.

We step forward with this statement because of our deep concern that the changes H.R. 3838 would make in the foreign tax rules would be, for the most part, deleterious for our industry and for the U.S. economy. In particular, we are concerned that many of the proposed changes would adversely affect the ability of U.S. companies to compete effectively in the world markets. And this would come at a time when all multi-national businesses within our economy -- including the insurance business -- need to find ways to compete better in the foreign markets, to aid in the vital endeavor of shrinking or eliminating our cavernous trade deficit.

In the following discussion, we undertake to address some six sets of changes in what we generally describe as the foreign tax rules -- more specifically, the changes proposed in the rules concerning controlled foreign corporations, the foreign tax credit, the sourcing of income, and the excise tax on foreign reinsurance premiums. Naturally, in all of this, we focus our remarks and requests for relief or clarification on the special way that the existing and proposed rules operate on insurance companies and their foreign operations.

I. Definition of Insurance Income (Sections 952 and 953 of the Code, Section 621(b) of H.R. 3838)

Section 952 of the Code specifically includes, as income currently taxed to the shareholders under "subpart F" (sections 951-964 of the Code), a controlled foreign corporation's "income derived from the insurance of United States risks." Section 953 defines that term to mean income, including income derived from investments, which is attributable to the issuing or reinsuring of any insurance or annuity contract in connection with U.S. risks. Section 953 also provides a de minimis rule which excludes income from the insurance of U.S. risks that is otherwise subject to subpart F if it constitutes five percent or less of the total premium-type income of the insurance company. In general foreign insurance income, including investment income, is granted deferral, except for that related to the insurance (or reinsurance) of U.S. risks.

The provisions of H.R. 3838 would expand considerably the "insurance income" that would be subjected to current taxation under the subpart F rules. The bill's proposed new definition would include as insurance income subject to immediate repartriation any income attributable to issuing (or reinsuring) any insurance or annuity contract in connection with risks in a country other than that in which the insurer is created or organized. The five percent de minimis rule of current law would also be repealed by the bill.

The effect of these proposals (and certain related proposals, which would amend section 954 of the Code) is to continue to subject to current tax the income from the insuring of U.S. risks, and to expand it to the current taxation of all the insurance income (i.e., investment and underwriting income) attributable to the coverage of all risks outside the foreign insurer's country of incorporation. Thus, world-wide insurance income would now be subject to current taxation with one exception: only the underwriting income connected with country-of-incorporation risks would continue to receive deferral.

For the reasons we presently set forth, we believe that current section 953 should not be changed. In our view, the income from the insurance of U.S. risks should continue to be taxed currently under subpart F (as is the income from the insurance of related persons' risks in countries outside the insurer's country of incorporation). With this exception, the foreign-source insurance income of a controlled foreign insurance company, including the company's investment income, should continue to be granted deferral, since it is the income of a legitimate, active foreign business. Also, we urge that the five percent de minimis rule be retained. (As a related matter, see also our discussion below concerning "Investment Income of Insurance Companies Included in Foreign Personal Holding Company Income", addressing the proposed repeal of section 954(c)(3)(B) and (C). Those provisions also must be retained to maintain the deferral allowed by current law, since the investment income to which they relate is an integral part of an insurance company's operation.)

Current Taxation of World-Wide Insurance Income. The provisions of subpart F have never before attempted to repatriate currently the earnings of foreign multi-national insurers with U.S. ownership, except for income related to coverage of U.S. risks (section 953(a)) and any investment income in excess of earnings on reserves and certain surplus (section 954(c)). Rather, they have recognized that such earnings belong to legitimate, actively conducted insurance businesses, and have respected the general rule that corporate income is not taxable to the shareholders until distributed.

The relevant facts have not changed: there is a U.S.-owned, foreign-based international insurance business of significant proportion. This business can hardly be dismissed as the "offshore incorporated pocketbooks" of domestic taxpayers. As noted by insurance scholars David Bickelhaupt and Ran Bar-Niv in their 1983 publication for the Insurance Information Institute, International Insurance (pages 34-35):

> "The total insurance premiums received by life and non-life U.S. insurers outside the U.S. totaled $6 billion in 1980. The regional breakdown was estimated as follows: Europe, 66 percent; Far East, 20 percent; Latin America, 11 percent; and the rest of the world, 3 percent [footnote omitted]. The American Foreign Insurance Association (AFIA) wrote premiums of about $1 billion by the beginning of 1980 and the 10 largest stock and three largest mutual property-casualty insurance companies wrote almost another $1 billion of direct premiums outside the U.S.
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> . . . .
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> "Much international insurance business accompanies foreign direct investment (FDI) in other contries. U.S. businesses, for example, have their U.S. insurers protect their investments through subsidiary or affiliated insurers operating in other countries. . . .
>
> "About 13,000 insurers operate in the 69 major countries of the non-Communist Bloc and about 2,500 or 20 percent of these operate outside their own home countries. The U.S. and U.K. accounted for 54 percent of these insurers that operate internationally. In the U.S. (including Puerto Rico), of more than 5,000 insurers about 630 insurers operate outside the U.S. . . . ."

Bickelhaupt and Bar-Niv also list among the "major reasons for international operations" of insurers: following U.S. business to other countries; profits, with high potential in expanding economies; spread of risks; enhanced competition; and enhanced reputation.

In justifying the proposed major revisions in the subpart F rules, the Ways and Means Committtee report reasons that it is appropriate (to prevent tax avoidance) to tax currently "movable income" earned through a foreign corporation that "could often be earned through a domestic corporation instead," and that "[i]nsurance income generally represents the type of inherently manipulable income at which subpart F is aimed, since such income can frequently be routed through a corporation formed in any convenient jurisdiction" (pages 391 and 395 of H.R. Rep. 99-426).

While this characterization may well be true of the income earned by so-called "captive" insurers of domestic non-insurance firms -- a problem that is already addressed in part by the existing subpart F rules, and the balance of which is being addressed in the evolving case law on such captives -- it simply cannot be applied to the income of the actively conducted businesses described above. As should be evident from the facts summarized, the latter are legitimate foreign commercial enterprises of major proportion, not merely investment accounts containing "movable income." (To some extent all corporate income may be "movable," but this has never been considered a reason to tax shareholders on it prior to distribution, and the current Committee report does not contend otherwise.) Further, the investment income earned by these foreign insurers (whether relating to reserves or surplus) is not a separate, dispensible element of their operation, but rather is integral to it: all insurers rely on investment income, together with premiums, to cover their costs of doing business. (Again, see our discussion of "Investment Income of Insurance Companies Included in Foreign Personal Holding Company Income," below.)

It is also not the case that the income of these U.S.-owned foreign insurers could have been earned through a U.S. Corporation instead (a point that, again, seems aimed at the non-insurance firm's "captive" insurer). In many instances, in operating abroad it is necessary for an insurer to do a foreign multi-national business out of a foreign corporaton, particularly to avoid the trade and tax barriers that other countries erect against U.S. branch operations. For example, within the European Economic Community it is vital for an insurer to be incorporated within a member country, for under the EEC's freedom-of-services rules such an insurer may conduct business in all the member countries with greater ease, whereas a non-member country insurer is faced with competitive disadvantages (see page 82 of International Insurance).

It would therefore be damaging to the competitive posture of U.S.-owned foreign insurers conducting a foreign insurance business to burden them with the requirements that would be imposed by the proposed expansion of the subpart F rules. Rather, consistent with the U.S. trade policy priority of promoting the sales of U.S.-owned services abroad -- including insurance services -- foreign insurers should be permitted to have their incomes taxed by the jurisdictions in which they operate, just as their competitors do.

De Minimis Rule. The five percent de minimis rule of section 953(a) provides that the basic rule -- the current taxation of insurance income arising from the insurance (or reinsurance) or U.S. risks -- does not apply unless the controlled foreign insurance corporation receives premiums or annuity considerations representing U.S. risks which are in excess of five percent of their total premiums and considerations. This rule was originally included in section 953 because various U.S. insurance trade associations brought to the attention of Congress the heavy burden a number of foreign insurance companies would have complying with the House provision, and that the I.R.S. would have in enforcing it. The basic problem was the tremendous work required to trace the ownership of a small number of policies or the location of various property.

For example, without a five percent de minimis rule, the new definition of insurance income proposed in the bill would apply to the insurance by any controlled foreign insurance company of one or more risks. To illustrate, consider the following:

Case 1. -- A Canadian life insurance company is wholly owned by a U.S. life insurance company. The Canadian company does not do business within the United States. The U.S. parent does not reinsure with its Canadian subsidiary. The Canadian subsidiary issues a group life insurance contract to a Canadian employer which covers its employees. Several of these employees are residents of the United States. Absent a de minimis rule, section 953 would apply to this case and the U.S. parent would have subpart F income of a small number of dollars. It is submitted that this example does not in any way represent any abuse of the tax law, and it should not be the purpose of section 953 to cover this case.

Case 2. -- Assume the basic facts of case 1, except that, at the time the group contract was issued, none of the employees were residents of the United States. Later, one of the employees moves to the United States and becomes a resident. At that time, presumably, the parent U.S. company would become subject to the provisions of section 953 absent a de minimis rule. Again, it is submitted that this is not an abuse situation which needs correction. In fact, the place where the employee resides is completely out of the control of the insurance companies involved. A variation of this case involves the Canadian or other foreign subsidiary that insures the life of an American citizen residing abroad, who thereafter returns to reside in the United States (perhaps years after the policy has been issued). Again this type of case is not an abuse area to which section 953 should be applied.

It is believed that the amount of revenue involved under the five percent rule is negligible. To our knowledge, loss of revenue has not been alleged as a reason for the proposed repeal of the five percent rule. To avoid the problems illustrated above, the rule should be retained.

II. Investment Income of Insurance Companies Included in Foreign Personal Holding Company Income (Section 954 of the Code, Section 621(a) of H.R. 3838)

Section 954(c)(3)(B) and (C) of the Code excludes from foreign personal holding company income dividends, interest, and gains from the sale or exchange of stock or securities derived from the investments made by an insurance company of (1) its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business and (2) an amount of its assets equal to one-third of its premiums earned on insurance contracts (other than life and annuity). The effect of these two exclusions is to permit deferral of this investment income.

Section 621(a) of H.R. 3838 would repeal these two exclusions. Thus, the U.S. shareholders of a controlled foreign insurance corporation would be subjected to U.S. tax currently on the corporation's investment income arising from its insurance business. (And as we just explained, by virtue of changes proposed in section 953 of the Code, most other insurance income of the corporation similarly would be taxed currently.)

We urge that section 954(c)(3)(B) and (C) of existing law not be repealed. The investment income of a foreign insurance company is an integral part of its insurance business and, like all other income of that company, should not be taxed by the U.S. until distributed to the U.S. shareholder(s).

The reason for the section 954 exclusions is that an insurance company derives its income from two sources, investment earnings and underwriting gain (or loss). Investment income is the portion of a company's insurance income which is derived from its investments, e.g., interest, dividends, rents, and royalties. Underwriting income (or loss) is the amount which an insurer gains (or loses) as a result of its risk-taking (or underwriting) process, i.e., the sum of premiums received for insurance coverages less claims, insurance reserves, and expenses related to the underwriting of risks.

If the insurance income of controlled foreign corporations is generally to be deferred (consistent with the overall scheme of the existing subpart F provisions), then both underwritng income and investment income must be deferred. While existing section 953 permits such deferral (for both type of income), since section 954 generally includes within the reach of subpart F the income from investments (specifically, foreign personal holding company income as defined in section 553 of the Code), it is necessary to except out of that provision the investment earnings of the foreign insurer. This is done by section 954(c)(3)(B) and (C).

Of course, it is in connection with the proposed broadening of the scope of section 953, resulting in the current taxation of all the insurance income of a controlled foreign corporation (other than underwriting income on country-of-incorporation risks) that the section 954 exclusions are proposed to be repealed. However, as explained in our above discussion of the "Definition of Insurance Income", the existing section 953 rules are correct and should be retained, thus treating all of the controlled foreign corporation's insurance income -- including its investment income -- as outside the scope of the subpart F rules (other than, perhaps, the limit on surplus earnings found in section 954(c)(3)(C)) and therefore eligible for the usual deferral until it is distributed. Accordingly, there is no need to alter the section 954 exclusions in light of the section 953 rules.

Moreover, in view of the fact that the investment income earned by foreign insurers (whether relating to reserves or surplus) is not a separate, dispensible element of the their operation, but rather (as for all insurers) an integral part of the business of insuring risks, there is no independent reason to change section 954. Indeed, the magnitude and importance of investment income in relation to total insurance income is seen in the operating results of U.S. property-casualty insurers. As shown in the data appearing on pages 19-20 of Insurance Facts, 1985-86 Property/Casualty Fact Book (an Insurance Information Institute publication), for the period 1968-1984 there was an aggregate underwriting loss (again, premiums less claims, reserves and expenses) in excess of $65 billion. For the same period, however, there was aggregate investment income of approximately $130 billion, yielding a positive total insurance income (despite the underwriting loss) of $65 billion. Without the investment income that is so integral to their operations, the U.S. property and casualty insurers would not have been able to pay their claims. It is believed that these results are consistent with those of the property and casualty industry world-wide.

Similarly, the magnitude and importance of investment income for life insurance companies may be seen from the data on page 55 of the 1984 Life Insurance Fact Book (as published by the American Council of Life Insurance). For example, of the total receipts of U.S. life companies in 1983 ($176.0 billion), 28.9 percent ($50.9 billion) was derived from investments, 67.6

percent ($119.0 billion) was attributable to premiums, and the remaining 3.5 percent came from miscellaneous sources. It should therefore be evident that for life insurers as well as property and casualty insurers, and foreign insurers as well as domestic insurers, investment earnings are integral to the business they conduct and are very much inseparable from their total insurance income.

Accordingly, the rules of section 954 (and section 953) relating to insurance income should not be changed. The legitimate, U.S.-owned foreign commercial enterprises that constitute a significant portion of the international insurance business should not have any part of their income on non-U.S. risks, whether that income is derived from investment or underwriting activities, treated differently under subpart F than is provided under current law.

III. Separate Foreign Tax Credit Limitation for Insurance Income (Section 904 of the Code, Section 601 of H.R. 3838

Section 904 of the Code imposes a limitation on the amount of foreign tax credits that can be claimed in a taxable year. The overall foreign tax credit limitation is calculated separately for certain categories of income (e.g., DISC dividends, passive interest income). Insurance income, including interest income of insurers, has never been subject to a separate foreign tax credit limitation.

Section 601 of H.R. 3838 would subject "banking or insurance income" to a separate foreign tax credit limitation. "Insurance income" is defined as income which is derived from (1) the investment made by an insurance company of its unearned premiums or reserves ordinary and necessary for the proper conduct of its insurance business, and (2) any income from the issuing or reinsuring of any insurance or annuity contract (regardless of whether the risk insured is in the country of incorporation).

While we do not object to the amendment that would be made by section 601 of the bill, we do request that its content be clarified to assure that all insurance activities will be included in the same "pool" of income and expenses, albeit treated separately from non-insurance activities. Specifically, it should be made clear that both net investment income (whether attributable to reserves or surplus) and net underwriting income of all insurance operations, including foreign branches and controlled foreign corporations, are included in the insurance income "pool."

The Ways and Means Committee report of H.R. 3838 aptly describes the amount of a domestic corporation's foreign income that would be subject to the proposed separate limitations as "the amount that would be taxed under subchapter L . . . if it were the income of a domestic insurance company (subject to the modifications provided in Code section 953(b))" (page 338 of H.R. Rep. 99-426). This would appear to include within the same limitation all of the income and expenses of an insurance company attributable to its investments (relating to surplus as well as reserves) and all of its income and expenses attributable to its underwriting activities, in that subchapter L covers all such items without differentiation in computing an insurance company's taxable income. It would also seem to include within that limitation all foreign insurance branch income from investment and underwriting activities, since that income "would be taxed under subchapter L . . .", as well as the subpart F income generated by controlled foreign insurance corporations (such as from the coverage of U.S. risks), since that income "would be taxed under subchapter

L . . . (subject to the modifications provided in Code section 953(b))."

As drafted, however, section 601 of the bill itself, and new section 904(d)(2)(B) that the bill would add to the Code, do not clearly provide for the treatment indicated in the Committee report. In particular, subparagraph (B) of the new Code provision gives the appearance of including the investment income of an insurer (described in clause (i) of the subparagraph) under a limitation that is separate from, rather that part of, the limitation applicable to all other income of the insurer (described in clause (ii)). Further, clause (i) mentions only the investment income attributable to unearned premiums and ordinary and necessary reserves, potentially leaving in question the treatment of investment income attributable to the insurer's surplus -- surplus that is integral to the insurer's business of underwriting risks and without which the insurer cannot function.

In addition, in referring to the insurer's income in clause (ii) of new subparagraph (B), the bill refers to income "of a kind which would be insurance income as defined in section 953(a)" as further amended by the bill. This language leaves somewhat unclear the treatment of foreign insurance branch income for purposes of the new separate limitation.

Accordingly, if section 904 of the Code is to be amended to subject insurance income to a separate limitation, the amending language should be clarified to remove any such questions, consistent with the explanation in the Committee report. As so clarified, new section 904(d)(2)(B) might read:

> "(B) BANKING OR INSURANCE INCOME. -- The term 'banking or insurance income' means income (whether or not derived from investments) received or accrued by any person which is derived from the conduct of --

"(i) a banking, financing, or similar business, or

"(ii) an insurance business and which is taxed under subchapter L of this chapter or which would (subject to the modifications provided by paragraphs (1) and (2) of section 953(b)) be so taxed if such income were the income of a domestic insurance company."

In addition, the intent of this revision might be explained as follows (referring to page 338 of H.R. Rep. 99-426):

> "The amount of insurance income subject to the separate limitation is the amount that is taxed under subchapter L of the Code (as modified by the bill) or that would be taxed under subchapter L if it were the income of a domestic insurance company (subject to the modifications provided in Code section 953(b)). Thus, both net investment income (whether attributable to reserves or surplus) and net underwriting income of all insurance operations, including foreign branches and controlled foreign corporations, are included in the 'pool' of insurance income that is subject to the separate limitation."

IV. Treatment of Certain Withholding Taxes on Interest Income Received by Insurance Companies (Section 901 of the Code, Section 602 of H.R. 3838)

In general, foreign withholding taxes on interest income are creditable taxes as "in lieu of" income tax. However, section 602 of the bill would provide that no foreign tax credit is allowed for any withholding tax (or other tax determined on a gross basis) imposed on interest income or its equivalent that is received by an insurance company (or bank) to the extent that the tax exceeds the U.S. tax which is attributable to the associated interest income.

We urge that this proposal be deleted from H.R. 3838. As already noted in our discussion above, section 601 of the bill subjects banking and insurance income to a separate foreign tax credit limitation. The Ways and Means Committee report, (page 340 of H.R. Rep. 99-425) states, in part, as follows in explaining this provision:

> "The rule excluding high-taxed income from the passive income basket does not apply to income in either the banking and insurance income basket or the shipping income basket. This reflects the judgment of the committee that a bona fide bank, insurance company, or shipping company, while it should not be able to average its banking, insurance, or shipping income with any other, unrelated types of income, generally should be able to obtain the benefits of foreign tax rate averaging with respect to its active business income to the same extent that, for example, a manufacturing or service enterprise can."

We stated in our comments on section 601 of the bill that we believe the definition of "insurance income" needed to be clarified to make certain that investment income (e.g., interst income) be included within the insurance "pool." Moreover, our comments with respect to section 621(a) and (b) of the bill confirm that investment (including interest) income is part of insurance income.

Since the Ways and Means Committee desired to continue to permit bona fide insurance companies to be able to obtain the benefits of foreign tax averaging with respect to its active insurance business income, the restriction imposed by section 602 is contradictory to the Committee's purpose. Therefore, it should be dropped from the bill.

V. Allocating Interest and Other Expenses to Foreign Source Income (Section 864 of the Code, Section 614 of H.R. 3838)

The Code provides, in general terms, that taxpayers, in computing net U.S. source and foreign source income, are to deduct from U.S. and foreign source gross income the expenses, losses, and other deduction properly allocated or apportioned thereto. This allocation is to be determined on a separate company basis. Moreover, tax-exempt income and assets generating tax-exempt income are, in general, permitted to be taken into account in allocating

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deductible expenses.

Section 614 of the bill would provide, in general, that for purposes of the foreign tax credit limitation of section 904, the taxable income of each member of an affiliated group from sources outside the U.S. is to be determined by allocating all interest expenses as if all members of the group were a single corporation. Thus, the allocation of interest expense would be determined on a group basis rather than a separate company basis. An exception to this new group basis rule was made for financial institutions. Moreover, section 614 provides that tax-exempt assets and income associated therewith are not to be taken into account in allocating or apportioning any deductible expense (other than interest expense).

We strongly recommend that the financial institution exception be extended to insurance companies, and that the provisions of existing law taking into account all assets, including assets which produce tax-exempt income, in allocating expenses be retained.

Extension of Exception. Section 614 contains an exception to the general rule requiring treatment of an affiliated group as if all members of the group were one taxpayer for purposes of allocating interest expenses. Under this exception certain financial institutions -- banks, savings and loans, mutual savings banks, etc. -- will not be treated as members of the group for interest expense allocation purposes. Thus, the current law rule (separate company basis allocation) is continued for these financial institutions. Specifically, the financial institution exception applies if the institution's business is predominantly with persons other than related persons or their customers, and if the institution is required by State or Federal law to be operated separately from any other entity which is not a financial institution.

Insurance companies are rquired by State law to operate separately from any other entity which is not an insurance company. In fact, most State laws do not permit a life insurance operation to be conducted in the same entity as a property and casualty insurance operation. Thus, the rationale of the special rule for financial institutions is equally applicable to insurance companies. Accordingly, the bill should be amended to grant the same exception to insurance companies.

Tax-Exempt Income. In allocating or apportioning expenses, it is appropriate to consider all assets of the corporation. To date, this has been the approach taken in the Treasury Department's regulations. By definition, no allocation formula is perfect. Rather, its function is to allocate expenses in a reasonable and economically efficient manner. Underlying the formula in existing law is the general recognition that expenses which are inherently readily identifiable as to source (U.S. or foreign) are best allocated by reference to the situs of the asset base. No attempt was made to identify the relative value or timing of future income yield from various assets, much less the taxable status of the income derived from such assets. There refinements were irrelevant (and costly) to the task at hand: the allocation between U.S. and foreign sources of properly deductible expenses so fungible as to be identifiable only by reference to the location of the assets.

Refinements of the nature proposed in the bill are an attempt to make "precise" an allocation formula that by definition, is incapable of complete accuracy (because of the nature of the expenses being allocated). Further attemps at precision would force one to make decisions with respect to assets which do not produce income (e.g., cash on hand or held in non-interest bearing accounts, furniture and fixtures); assets which currently are producing no income (investments such as undeveloped land, non-dividend paying stock, loans in default); and assets which may produce capital gain income rather than ordinary income. These refinements, and others of a similar nature, would only complicate and make more costly an asset allocation formula without, in all likelihood, measurably increasing its accuracy. Accordingly, the change proposed -- to exclude assets that generate tax-exempt income -- should be deleted from H.R. 3838.

Suggested Statutory Changes. To remove insurance companies from the scope of the proposed rules, a new subparagraph might be included within proposed section 864(e) of the Code (as would be added by section 614(a) of the bill) by renumbering proposed section 864(e)(6) to (7) and inserting in lieu thereof the following:

> "(6) SPECIAL RULE FOR CERTAIN INSURANCE COMPANIES. -- The first sentence of paragraph (1) shall not apply to any insurance compay taxed under subchapter L if --
>
> "(A) the business of such insurance company is predominantly with persons other than related persons of their customers, and
>
> "(B) such insurance company is required by State [or Federal] law to be operated separately from any other entity which is not such an insurance company.
>
> Such insurance company shall not be treated as a member of the group for purposes of applying such first sentence to other members of such group"

In addition, to remove the new rule regarding tax-exempt interest, paragraph (3) of proposed new subsection 864(e) (as contained in section 614(a) of H.R. 3838) should be deleted.

VI. Excise Tax on Insurance Premiums Paid to Foreign Insurance Companies (Section 4371 of the Code, Section 654 of H.R. 3838)

Section 4371 of current law imposes an excise tax on any direct insurance transaction with a foreign insurer (not subject to U.S. income tax), and an additional tax on any reinsurance transaction with a foreign reinsurer, if the transaction involves the insurance or reinsurance of a U.S. risk. The excise tax is imposed at the rate of (1) four cents on each dollar (or fraction thereof) of the premium paid for casualty insurance and (2) one cent on each dollar (or fraction thereof) of the premium paid on policy of reinsurance covering casualty insurance.

Section 654 of the bill would increase the excise tax imposed on the reinsurance of U.S. casualty risks to four percent of the premium received by the foreign insurer. It would also modify the existing tax rate on direct insurance with a foreign insurer from a rate of four cents on each dollar (or fraction thereof) of the premium paid to a rate of four percent of the premium paid. Finally, it would adopt a withholding provision in the administration and collection of the excise tax.

The Rate Increase. The rate increase on casualty* reinsurance is proposed as a tax reform measure, designed to prevent U.S. insurers from avoiding the "proper level of excise tax by careful structuring of insurance and reinsurance transactions." Although the Committee report does not elaborate, it is intended to eliminate any possible tax advantage in using a domestic insurer to "front" for a foreign carrier.

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* Life insurance is taxed at 1%, and the rate on life reinsurance would remain at 1%.

Under a fronting arrengement, the direct insurance would be placed with a domestic insurer which would then reinsure the bulk of the coverage (and, coincidentally, the premium) with a foreign insurer. Under current law, no excise tax would be due on the first transaction (though a state premium tax would be due, and these rates are typically 2-3%), but a 1% excise tax would be due on the reinsurance placement. The Committee Report assumes that the two transactions in the example would be eliminated and a single transaction subject to a 4% excise tax would be the norm. Implicit in the Committee report is an assumption that the placement with a domestic insurer is purely a tax avoidance device without validity as a business measure.

If that were the case, ample precedent exists to attack the transaction under existing law. In Aiken Industries. 56 T.C. 925 (1971), the Tax Court denied an exemption for interst paid from a U.S. corporation to a Honduran corporation where it found that there was no "business purpose" for the transfer of notes from the Bahamian parent to the Honduran subsidiary, other than tax avoidance. The U.S. corporatation, a second-tier subsidiary of the Bahamian parent, had borrowed $2,250,000 from the Bahamian parent at 4%. The parent transferred the U.S. corporation's note to its Hondures subsidiary in exchange for nine notes totalling $2,250,000 at 4% - a mirror transaction in which the Honduras corporation was obligated to pay to the Bahamas corporation exactly what it received from the U.S. corporation. The court denied the exemption on the ground that the Honduras corporation was "merely a conduit for the passage of interest payments." 56 T.C. at 934. See also Court Holding Co. v Comm'r., 324 US 331 (1945) Gregory v. Helvering, 293 US 465 (1935). A business purpose analysis of the fronting transaction described above would disregerd insurance premiums paid to a U.S. insurer, where it served as a "mere conduit" for purported reinsurance premiums to a foreign insurer. Reinsurance premiums paid to a foreign insurer would then be subject to the tax at the 4% rate for direct premiums.

If the rate increase were adopted, however, it would affect many legitimate reinsurance transactions having no tax avoidance purpose. All reinsurance transactions would be affected, not merely those questionable transactions having a tax avoidance motive and lacking a "business purpose."

As a tax reform measure, the rate increase is overly broad. Its objectives can be achieved under current law without adversely affecting ordinary reinsurance transactions. Its objectives can be obtained without imposing very high costs upon insurers (and ultimately U.S. policyholders) in their routine business transactions where no tax avoidance motive exists.

This rate increase comes at a time when the domestic industry is unable to satisfy the demands of U.S. policyholders for insurance and is actively searching out foreign carriers to provide additional capacity. The U.S. Department of Commerce, reported that available property casualty insurance could fall short of demand by as much as $62 billion over the next 3 years. The Commerce Department, which relied upon a study by the Insurance Services Office, a private sector organization that supplies a wide range of rating, actuarial and statistical services, noted that 91% or $56.2 billion of the $61.8 billion shortfall for the period 1985-87 would be in commercial lines, i.e., insurance for businesses, organizations, governmental agencies, and others. The study found that "availability of insurance is down, cost is up -- in many cases by 300 or 400 percent -- and coverage is increasingly restricted." 1986 U.S. Industrial Outlook at 51-6. Some of the examples of troubled lines include environmental liability, product liability, long-haul trucking liability, directors' and officers' liability, medical malpractice, professional liability for lawyers, accountants, architects and engineers, municipal liability, and occupational disease. Increasing the rate of all foreign reinsurance would inevitably contribute to the increases in premiums to U.S. policyholders and would impair U.S. companies' efforts to obtain much-needed additional capacity.

Increasing the rate on casualty reinsurance from 1% to 4% would represent a more substantial increase in costs, than it may appear to observers outside the industry. Because the tax is imposed upon the gross premium, without any recognition of the related costs insurers must bear, it has the same impact of a rate increase on net income many times its size. In reinsurance, where profit margins are often narrow, the additional tax will inevitably force an adjustment of premiums (or a reduction of coverage) in recognition of the additional tax.

Finally, the rate increase is not appropriate or necessary as a means of protecting the domestic industry from competition with foreign companies. In its discussions of the revision of taxation of casualty insurers, the American Insurance Association has not sought to have additional protectionist taxes imposed upon foreign companies. The Association has been concerned that the increase imposed as tax reform measures could produce such substantial revenuos that the domestic industry might be at a comparative disadvantage, unless the revenue total were monitored carefully and balanced by these competitive concerns.

For the foregoing reasons we believe the excise tax on casualty reinsurance should not be raised from one percent to four percent.

The Withholding System. The bill would institute a new withholding system for the excise tax which would apply to both direct insurance and reinsurnce. Under current law, the tax is collected by the resident party which transmits the premium to the foreign insurer -- ordinarily the broker, but in some cases, the U.S. policyholder. The bill would require the U.S. broker or policyholder to withhold the tax. On its face, this change appears only to focus the responsibility for collecting the tax upon the two parties who ordinarily remit the tax under the present system. While we appreciate the concern of Congress that amounts due are properly collected, the restructuring of the tax would impose an unwieldy and costly record-keeping burden upon U.S. brokers and insurers, whose cost cannot be justified by the slight increase in receipts that might result. The bill would impose the tax upon "premiums retained," that is, gross premiums net of reinsurance. To determine the tax, the foreign insurer must calculate the amount of reinsurance attributable to a single contract. If reinsurance were written to underwrite a single contract, (as the Committee report assumes), the calculation would be straightforward. However, this is not common practice. Direct or "faculative" reinsurance of a single risk is exceptional. Ordinarily, an insurer, whether U.S. or foreign, purchases reinsurance for a line of business or its entire book of business - not a single contract. Reinsurance may be either a percentage of the risk ("proportional" or "quota share") or an amount in excess of certain agreed limits ("excess of loss.") A company ordinarily has a number of reinsurers providing different types of coverage. The bill would, presumably require some attribution of the premiums for each type of insurance to an individual contract - an extraordinarily complex calculation that would not be available at the time the contract is written. A U.S. company purchasing reinsurance directly from a foreign carrier would be required to maintain and submit records a year or more after the transaction. Where the amount subject to tax is uncertain (as it would be in nearly every case), the full amount of tax would be withheld, subject to a possible refund.

American insurers would be subjected to burdensome recordkeeping requirements that would require foreign companies to remit information about "retained premiums" long after the transaction has occurred. These record-keeping requirements are unworkable and unjustified. We cannot help but be concerned that the adoption of such an unreasonable requirement for U.S. business would lead some companies to increase rates or withdraw from the U.S. market, at a time when domestic companies need the additional capactiy provided by foreign insurers.

To avoid the problems discussed above, the withholding requirements should be deleted.

STATEMENT OF THE
AMERICAN PETROLEUM INSTITUTE

Submitted To The

UNITED STATES SENATE COMMITTEE ON FINANCE

Regarding

HEARINGS ON THE ECONOMIC EFFECTS OF H.R. 3838 ON INTERNATIONAL COMPETITIVENESS AND CAPITAL FORMATION

Washington, D.C.

January 29 - February 6, 1986

Introduction

H.R. 3838 derives in large part from The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity of May 1985. Both this Committee and the House Ways and Means Committee took extensive testimony as to how the proposals would affect economic growth, international competitiveness and capital formation. On July 17, 1985, the American Petroleum Institute (API) filed a comprehensive statement of its views on the effects of the President's proposals on domestic and foreign operations of the petroleum industry which we would like to incorporate by reference in this statement.

This statement concentrates on the economic effects of H.R. 3838 on international competitiveness and capital formation. The statement first focuses on the three arenas in which U.S. companies would be seriously handicapped in competition with foreign companies -- in the United States, in foreign host countries, and in foreign non-host countries -- and describes the anticompetitive impact of H.R. 3838 in each of these three situations. This statement then addresses those provisions of H.R. 3838 which most affect the formation of capital in the petroleum industry. For the reasons set forth in the following sections, we believe that no changes in the current law affecting foreign operations and capital cost recovery allowances are warranted.

I. INTERNATIONAL COMPETITIVENESS

A. Competition in the United States

U.S. multinationals compete in the United States with domestic corporations owned by foreign multinationals and with domestic corporations owned by U.S. shareholders. Changing the rule for allocating and apportioning deductions for interest, research and experimental expenditures, stewardship expenses, legal and accounting fees, income and other taxes, charitable contributions, etc., from the present separate company basis to the proposed new consolidated basis, would affect companies differently. U.S. multinationals would effectively be denied full U.S. tax relief for expenses actually incurred in connection with their U.S. operations merely because they happened to own stock in affiliated corporations doing business abroad. Their competitors would not be so affected.

A U.S. subsidiary of a U.S. multinational, for example, may be competing with a U.S. subsidiary of a foreign multinational with purely domestic operations in exploring for and developing petroleum reserves in the U.S. Under present law the financing costs of the two competitors would be identical both before and after tax. Under Section 614 of H.R. 3838, however, the after-tax financing costs of the former would be increased, whereas those of the latter would not. U.S. tax policy should not give foreign owned corporations an arbitrary competitive advantage over U.S. owned corporations.

In addition, the proposed repeal of the investment tax credit (ITC) and the Accelerated Cost Recovery System (ACRS) and other changes discussed more fully in Section II of this paper would make it more difficult for U.S. manufacturers to compete with foreign businesses in supplying U.S. markets.

B. Competition in Foreign Host Countries

U.S. and foreign subsidiaries of U.S. companies compete in foreign host countries with local companies. They are equally affected by the tax laws of the host country at the corporate level. Under H.R. 3838, however, the United States would tax the earnings of the U.S. owned companies at the shareholder level more harshly than foreign countries do.

Section 621 of H.R. 3838 would greatly expand the subpart F rules and tax U.S. shareholders currently on the undistributed earnings of their foreign subsidiaries, whereas foreign shareholders are not generally taxed until earnings are distributed. Section 661 of H.R. 3838 would tax U.S. shareholders on foreign exchange gains on remittances which are not taxed to foreign shareholders. Section 614 of H.R. 3838 would create double taxation at the shareholder level by allocating certain expenses to the foreign affiliate for U.S. tax purposes which would not be deductible for foreign tax purposes. Foreign countries will not permit affiliates of U.S. companies to deduct interest, research and experimental expenses, etc. paid by other members of the U.S. group, so that the allocation effectively means such expenses would not be deductible. The effect of such treatment will be to encourage U.S. companies to relocate key activities such as research and development overseas. Some categories of income are not taxed by foreign countries, but would bear full U.S. residual tax under the separate basket rules of Section 601 of H.R. 3838. Collectively these fundamental changes in how the United States would tax income earned abroad would substantially handicap U.S. companies trying to compete with foreign companies in their host countries. The extreme delay proposed for recovery of IDC and the slowing of other capital cost recovery allowances for foreign operations could produce substantial timing differences in taxing income which could result in a residual U.S. tax that would exacerbate the competitive problem.

C. Competition in Foreign Non-Host Countries

U.S. corporations compete with foreign corporations in third countries in two ways -- by exporting from their respective countries, or by doing business in or trading among third countries.

1. U.S. Exports

The ability of exporters from the United States to compete with exporters from other countries would be damaged in the long run by the proposed repeal of the investment tax credit and the accelerated depreciation rules (sections 201-203 and 211). An analysis by Arthur Andersen & Co. found that in the critical capital intensive sectors, such as mining and manufacturing, U.S. capital cost recovery allowances would drop from fifth place internationally to the bottom of the list, substantially raising the after-tax cost of capital. The increased cost of capital for U.S. firms will lead to less investment in new plant and equipment within the U.S. and a consequent erosion ability to compete in the long run. (See section II for more detailed discussion of capital formation issues.)

U.S. exporters would also be damaged by the proposed changes in the source of income rules (section 611 of H.R. 3838). Under present law half of the income from exports is treated as U.S. source and half is sourced to the place of sale. Under the bill all income from exports would be treated as U.S. source unless the taxpayer restructures itself to satisfy very restrictive conditions. Moreover, sales to related parties will be treated as U.S. source despite the taxpayer's restructuring. As a matter of policy, the source of income rules should not be different depending upon whether a U.S. exporter sells to a related party or to an unrelated party. These rules would replace long established standards which have allowed U.S. taxpayers to compete in foreign markets.

2. International Trading Operations

In the international petroleum industry companies purchase millions of barrels of oil and gas daily in numerous foreign producing countries, transport it over international waters, and sell it to refining and marketing companies in numerous foreign consuming countries. Under present law all of this active operating income is foreign source and eligible for the foreign tax credit, subject to the limitations imposed by Sections 904 and 907 of the Code.

Sections 611 and 615 would treat such income as U.S. source and tax it currently if the operating company were incorporated in the United States. Although lip service is paid to the principle that the sourcing rules "should reflect the location of the economic activity generating the income" (H.R. Rep. No. 426, 99th Cong., 1st Sess. 360 (1985)), the proposed rule is based on country of incorporation, which has less to do with where the activity occurs than the passage of title test of current law.

The proposed source of income rules appear to have been developed for one purpose only -- to fragment income in order to raise revenue by imposing current U.S. tax on each and every transaction which has not borne current foreign tax regardless of the overall outcome of foreign operations. No consideration seems to have been given to basic principles of sound tax policy, such as internationally accepted standards followed by our trading partners, the effect on the competitiveness of U.S. or U.S.-owned companies, and the location of the underlying economic activity.

II. CAPITAL FORMATION

Another disturbing feature of H.R. 3838 is its impact on capital formation. API applauds the corporate rate reductions contained in H.R. 3838 and the implicit recognition that high rates diminish incentives to save and invest. However, changes to the capital cost recovery system envisioned by H.R. 3838 cause API to conclude that the overall impact of the bill on capital investments in the petroleum industry would be negative. These adverse effects would be particularly severe for deepwater and frontier projects which typically involve very long lead times, heavy tangible capital investments, and high risk. Even under current law, real cost recovery can be significantly eroded by even modest inflation rates due to the long lead times. H.R. 3838 would compound this problem by repealing investment tax credit and dramatically reducing the speed at which costs are recovered for tax purposes.

Additional more detailed discussion of the items contained in this section may be found in the attached statement submitted to the Committee by API on July 17, 1985.

A. Intangible Drilling and Development Costs (IDCs)

The current deduction of IDCs remains the most important aspect of capital cost recovery for petroleum exploration and production operations. Section 251 of H.R. 3838 would require 26 month amortization of post casing point domestic IDCs and 120 month amortization or cost depletion of IDCs incurred outside of the United States.

Under the recovery rules for IDCs, as modified by H.R. 3838, an integrated petroleum producer would deduct 80 percent of pre casing point IDCs as incurred, use 36 month amortization of 20 percent of pre casing point IDCs, 26 month amortization of post casing point IDCs, 120 month amortization of foreign IDCs, 60 month amortization of IDCs for earnings and profit purposes, and a complex computation for computing the IDC preference amount for minimum tax purposes.

Although unfortunate distinctions may have been made in their tax treatment, both the major integrated oil companies and the nonintegrated independents are needed to find and produce oil. Expensing of IDCs helps both do their job. Majors tend to drill fewer, more expensive wells, often in more hostile environments, but find larger reserves per well. Independents tend to drill more, less expensive wells. Each group makes a substantial contribution to the petroleum found in this country. Both are clearly needed. The current deduction for IDCs minimizes the adverse impact of the income tax on decisions to invest in oil and gas exploration and production. Delaying the recovery of drilling costs would reduce the financial attractiveness of petroleum exploration and production to both independents and majors.

The critical importance of expensing IDCs is aptly shown in the results of a recent API study of the impact of requiring capitalization of IDCs with recovery through cost depletion and depreciation as proposed in the November 1984 Treasury Department proposal. Postponing the recovery of IDCs would reduce drilling activity and future domestic petroleum production rates would be cut by almost 900,000 barrels per day of oil by 1990 and 1.6 million barrels per day by 1995. The predicted loss in 1995 would be more than twice the shortfall suffered by the U.S. in 1979 during the Iranian revolution. The Administration, in its tax reform proposal, recognized the adverse impact on domestic production and national security that would follow from slowing the rate of recovery of IDC and accordingly recommended no change in current treatment. The Committee is urged to do likewise.

B. Percentage Depletion

Under sections 252 and 253 of H.R. 3838 percentage depletion generally would be phased out over three years but would be retained for stripper wells owned by independent producers and royalty owners. Percentage depletion would not be allowable for lease bonuses, advanced royalties or similar payments.

Depletion is a capital recovery mechanism. An owner of an interest in an oil, gas, or mineral property incurs costs which, for tax purposes, are considered capital in nature. These include acquisition costs, such as lease bonuses, which are capital for financial and tax purposes and certain other costs, such as geologic and geophysical exploration costs, which are considered an expense item by accounting standards but are capitalized for tax purposes.

This capital must be recovered by "cost" depletion if percentage depletion is unavailable. Cost depletion is typically taken by the unit-of-production method -- which limits current capital cost recovery to that portion of the property's estimated total remaining output represented by current production. Thus, when a barrel of oil is produced, it is divided by the number of barrels of estimated remaining reserves and multiplied by the adjusted tax basis of the property involved to determine the amount of the current depletion deduction. For a long-lived property, this method of recoupment is the slowest method of capital recovery available under current law. Even very modest rates of inflation will very rapidly erode the real value of cost recovery deductions under the unit of production method. Real costs of capital invested have thus been "under-recovered" in recent years due to the effects of inflation. Moreover, estimation of remaining reserves is an inexact science at best, and is beyond the capability of most royalty owners or other holders of nonoperating interests who do not normally have access to the operator's reserve estimates.

API believes that percentage depletion remains an effective replacement cost recovery mechanism which encourages oil and gas exploration and production by recognizing the high risks and the enormous capital outlays required to replace reserves today in the industry.

C. Capital Cost Recovery -- Incentive Depreciation System (IDS)

The most disappointing feature of H.R. 3838 is the proposal to substitute an archaic and misnamed "Incentive Depreciation System" (IDS) for the existing Accelerated Cost Recovery System (ACRS) and to repeal the investment tax credit (ITC).

The proposed repeal of the ITC is a matter of serious concern to the petroleum industry. The ITC has provided a substantial boost to investment by serving three functions: (1) offsetting the bias of the income tax against investment; (2) serving as a surrogate for indexing depreciation; and (3) providing a source of funds for new investment. Its repeal would likely lead to a curtailment of investment in the petroleum and other capital intensive industries.

IDS provides much slower cost recovery rates than the Capital Cost Recovery System (CCRS) proposed by the President, the present law ACRS, or its predecessor Asset Depreciation Range (ADR) used from 1971 through 1980 (Figure 1).

For example, at the end of five years from the date of investment, oil and gas producers would recover only 53% of their original cost of well equipment under IDS in contrast to 100% recovery under ACRS, 92% recovery under CCRS (assuming 5% inflation) and 63% recovery under ADR. Even the Guideline Depreciation rules in effect from 1962 to 1970 would have yielded a slightly greater recovery during the first five years.

Similarly the present value (at a 10% discount rate) of the cost recovery allowance under IDS for oil and gas producing equipment is a dismal 66% of original cost compared to 83% under ACRS without ITC, or 100% with the credit. Under CCRS the present value would be 91%, and 72% under ADR without ITC or 94% with ITC. Even the 1962 Guidelines would have yielded 67% without ITC or 82% with the 7% ITC then in effect.

The drastic extension of recovery periods under IDS with only token provision for indexing will resurrect all of the problems of inflationary erosion of capital values which led to enactment of ACRS in the first place (Figure 2). In this respect IDS is by far the worst performer of the various systems considered recently. For example, at a moderate inflation rate of 5%, IDS provides recovery of only about 80% of real or replacement costs by the year 2000 while CCRS provides 100% of

Figure 1

COMPARISON OF COST RECOVERY PROPOSALS
(Assumes 5% Inflation)

Recovery Year	Percentage of Original Cost Recovered in Each Year								
	Present Law	President's Proposals(1)		H.R. 3838 (2)		Pre-1981			
						Production		Refining	
	5 Yr. ACRS Most Petroleum Plant & Equip.	Class 3 Production Equipment	Class 4 Refining Equipment	Class 5 Production Equipment	Class 6 Refining Equipment	ADR 11 Yr.	1962 G.L.	ADR 13 Yr.	1962 G.L.
1	15	16.5	11.0	7.7	6.3	9.1	7.1	7.7	6.3
2	22	28.9	20.6	14.2	11.7	16.5	13.3	14.2	11.7
3	21	20.4	16.8	12.0	10.2	14.1	11.8	12.5	10.6
4	21	14.3	13.9	10.2	9.0	12.6	10.8	11.4	9.8
5	21	12.2	14.6	8.6	7.8	11.1	9.9	10.3	9.1
5 Yr. Cumulative	100.0	92.3	76.9	52.7	45.0	63.4	52.9	56.1	47.5
6		12.8	15.4	7.3	6.9	9.7	8.9	9.2	8.4
7		6.7	16.1	6.2	6.0	8.2	8.0	8.1	7.7
8			8.5	5.2	5.3	6.7	7.1	7.1	6.9
9				5.2	4.6	5.2	6.1	6.0	6.2
10				5.2	4.3	3.7	5.2	4.9	5.5
11				5.2	4.3	2.2	4.2	3.8	4.7
12				5.2	4.3	.9	3.3	2.7	4.0
13				5.2	4.3		2.4	1.6	3.3
14+				2.6	15.0		1.9	.5	5.8
Total Percentage Recovery	100.0	111.8	116.9	100.0	100.0	100.0	100.0	100.0	100.0
Present Value @ 10%									
Without ITC	82.5	90.5	87.5	65.6	60.2	72.1	66.6	68.4	63.5
With ITC	100.0	(3)	(3)	(3)	(3)	93.8	81.8	90.1	78.7

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(1) Fully Indexed.
(2) Indexed only for 1/2 of inflation above 5%.
(3) ITC repealed.

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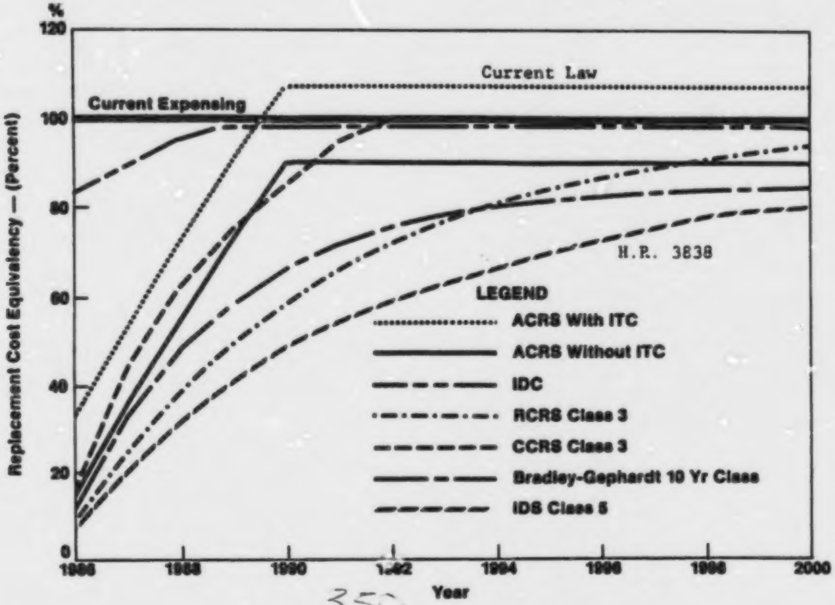
Figure 2

Comparison of Aggregate Allowances for Exploration and Production Under Various Cost Recovery Systems — 5% Inflation - No Real Growth



recovery by 1992. Although ACRS provides only about 90% recovery of real or replacement costs at 5% inflation, the ITC acts in part as a surrogate for indexing that makes up the difference.

Investment in new plant and equipment is quite sensitive to capital cost recovery rates. Projects that are only marginally attractive under present law would cease to be viable under H.R. 3838 even with substantial reduction in tax rates.

Figure 3 compares investment criteria and effective tax rates for a sample refinery modernization project under present law and various cost recovery systems, assuming a 12% "hurdle rate" on cost of capital and no change in the present 46% maximum corporate tax rate. This project would yield a 15.7% internal rate of return (IRR) before taxes and 14.6% after taxes under present law. The IRR drops to 12.4% with repeal of the ITC and to 10.0% if IDS is then substituted for ACRS, which would kill the project as uneconomic. The IRR could be increased to 12.7% if the President's CCRS were substituted for IDS, and the project would regain viability. Figure 4 demonstrates a similar relationship for the same project among various cost recovery alternatives assuming the tax rate is reduced to 35% as recommended by the Administration. Even with the lower tax rate, H.R. 3838 with Class 6 IDS yields a 20% lower IRR than under present law. Moreover, the IRR under H.R. 3838 at 35% is below that under ACRS without ITC at a 46% tax rate.

FIGURE 3

IMPACT OF VARIOUS TAX REGIMES ON A SAMPLE PETROLEUM INVESTMENT (REFINERY PROJECT)

Tax Rate: 46%
Inflation: 5%

	Before Tax (1)	Current Law ACRS/ITC (2)	Current Law Without ITC (3)	President's Plan CCRS Class 4 (4)	H.R. 3838 IDS Class 6 (5)	H.R. 3838 IDS Class 6 Indexed (6)	H.R. 3838 IDS Class 6 250% DB Indexed (7)	Pre-1981 13 Year ADR (Indexed) (8)	Current Expensing of Investment as Incurred (9)
Internal Rate of Return	15.7%	14.6%	12.4%	12.7%	10.0%	11.3%	11.7%	12.0%	15.7%
Net Cash Flow	2,800	1,648	1,512	1,644	1,512	1,823	1,772	1,714	1,512
Present Value of Net Cash Flow (10)	529	285	161	194	(1)	110	134	159	286
Tax Due		1,152	1,288	1,156	1,288	977	1,028	1,086	1,288
Actual Effective Tax Rate (11)		41%	46%	41%	46%	35%	37%	39%	46%
Present Value Tax (10)		244	368	335	529	419	394	370	243
Present Value Effective Tax Rate (12)		46%	70%	63%	100%	79%	75%	70%	46%
Marginal Effective Tax Rate (13)		7%	21%	19%	36%	28%	25%	23%	0%

(1) Assumes refinery modernization investment of $1,700K resulting in a net revenue stream of $4,500K and a net cash flow before taxes of $2,800K.
(2) Accelerated Cost Recovery System (5 Year Class), 8% ITC with no basis adjustment.
(3) Accelerated Cost Recovery System, but without ITC.
(4) Capital Cost Recovery System Class 4: 22% of unrecovered basis (indexed) with close out in 8th year.
(5) H.R. 3838 Incentive Depreciation System: 16 Year DDB with switch to straight line.
(6) Same as (5), but with remaining basis indexed.
(7) Same as (5), using 250% DB instead of DDB, and with remaining basis indexed.
(8) Pre-1981 ADR (Indexed): 13 Year DDB with switch to sum-of-the-years-digits, basis indexed for inflation.
(9) Current expensing of equity investment as incurred.
(10) Discounted at 10%.
(11) Tax Due divided by Net Cash Flow Before Tax.
(12) Present Value Tax divided by Present Value of Net Cash Flow before tax.
(13) Reduction in Internal Rate of Return as a percentage of Internal Rate of Return before tax.

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FIGURE 4

IMPACT OF VARIOUS TAX REGIMES ON A SAMPLE PETROLEUM INVESTMENT (REFINERY PROJECT)

Tax Rate: 35%
Inflation: 5%

	Before Tax (1)	Current Law ACRS/ITC (2)	Current Law Without ITC (3)	President's Plan CCRS Class 4 (4)	H.R. 3838 IDS Class 6 (5)	H.R. 3838 IDS Class 6 Indexed (6)	H.R. 3838 IDS Class 6 250% DB Indexed (7)	Pre-1981 13 Year ADR (Indexed) (8)	Current Expensing of Investment as Incurred (9)
Internal Rate of Return	15.7%	15.4%	13.4%	13.5%	11.5%	12.4%	12.7%	13.0%	15.7%
Net Cash Flow	2,800	1,956	1,820	1,921	1,820	2,056	2,018	1,974	1,820
Present Value of Net Cash Flow (10)	529	373	249	274	126	210	229	247	344
Tax Due		844	980	879	980	744	782	826	980
Actual Effective Tax Rate (11)		30%	35%	31%	35%	27%	28%	30%	35%
Present Value Tax (10)		156	280	255	403	318	300	281	185
Present Value Effective Tax Rate (12)		30%	53%	48%	76%	60%	57%	53%	35%
Marginal Effective Tax Rate (13)		1%	15%	14%	27%	21%	19%	17%	0%

(1) Assumes refinery modernization investment of $1,700X resulting in a net revenue stream of $4,500X and a net cash flow before taxes of $2,800X.
(2) Accelerated Cost Recovery System (5 Year Class), 8% ITC with no basis adjustment.
(3) Accelerated Cost Recovery System, but without ITC.
(4) Capital Cost Recovery System Class 4: 22% of unrecovered basis (indexed) with close out in 8th year.
(5) H.R. 3838 Incentive Depreciation System: 16 Year DDB with switch to straight line.
(6) Same as (5), but with remaining basis indexed.
(7) Same as (5), using 250% DB instead of DDB, and with remaining basis indexed.
(8) Pre-1981 ADR (Indexed): 13 Year DDB with switch to sum-of-the-years-digits, basis indexed for inflation.
(9) Current expensing of equity investment as incurred.
(10) Discounted at 10%.
(11) Tax Due divided by Net Cash Flow Before Tax.
(12) Present Value Tax divided by Present Value of Net Cash Flow before tax.
(13) Reduction in Internal Rate of Return as a percentage of Internal Rate of Return before tax.

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The optimum recovery system which provides complete neutrality is, of course, current expensing of equity investment. It does not reduce the IRR below its pre-tax level regardless of the tax rate. Current expensing eliminates taxes as an investment consideration, avoiding the necessity of an inflation adjustment, and provides as much (or more) tax revenue over the project life as any of the other cost recovery mechanisms at comparable rates.

Proposed accounting changes would require that construction-period interest expense and other indirect costs attributed to new investment be capitalized and recovered under the IDS system. This delay in cost recovery would further burden new investment. This additional burden would obviously fall on those projects requiring long lead times and only serves to create a bias in the Tax Code against such projects. Such tax penalties do not serve the long term economic interest of the United States.

As a result of the slower recovery rates and substantial disregard of inflation, adoption of IDS and capitalization of interest and other indirect expense would significantly reduce anticipated returns on new investment, increase the cost of capital, eliminate a number of otherwise viable projects, cause a substantial cut in business spending and invite an overall economic recession and resulting loss of jobs.

True reform should seek to minimize intrusion of the tax system into the investment decision process thereby maximizing economic growth and revenue generating potential.

D. Minimum Tax

Comments with respect to capital formation are not complete without review of the corporate minimum tax (CMT). As with most CMT proposals, H.R. 3838 tends to magnify the intrusion of the tax system into the investment decision process, impede economic growth, and risk a reduction in new business investment. Once a taxpayer is subjected to the CMT alternative, the internal rate of return and present value of the net cash flow on each new project is reduced. Many projects could lose their economic viability and be scrapped.

Once the CMT is triggered marginal effective tax rates over the life of a project rise and the present value effective tax rate could exceed statutory rates by an even wider margin. Rather than neutralizing the effects of taxes on investment, the CMT magnifies the distortion inherent in the regular corporate income tax and thrusts the tax system further into the investment decision process.

The basic flaw in the underlying rationale for the CMT is the fact that with few exceptions the alleged corporate "preferences" involve the issue of when costs should be deducted rather than *whether* such costs should enter into the computation of taxable income. Virtually all so-called corporate preferences are clearly costs incurred in earning taxable income and should be deducted in determining any tax intended to be based on net income.

In essence, most CMT proposals are simply parallel income tax structures with capital cost recovery rates that are much slower than those used under the regular corporate income tax. No effort is made to determine the most rational or efficient recovery period for costs which generate multiperiod income, or adjust any of the "norms" to reflect the impact of inflation. They simply substitute a slow and ill-conceived capital cost recovery rate as the "norm" for the carefully crafted provisions of existing law.

In comparing the corporate minimum tax proposed in H.R. 3838 with the criteria for an acceptable tax, we find that many of the objectionable features of earlier CMT proposals have been eliminated, but some remain.

A major flaw in the CMT proposed under H.R. 3838 is its failure to use a reasonable method of capital cost recovery as the "norm" in measuring the timing "preferences." H.R. 3838 would treat as a preference all depreciation in excess of that allowable under a straight-line recovery method using the 1962 depreciation guideline lives with no adjustment for inflation.

Those recovery rates are much slower than the accelerated rates permitted under the 1962 guidelines, such as double declining balance, sum-of-the-years-digits or a combination thereof. The major criticism of the guideline rates or the successor ADR rates was the lack of adjustment for inflation. The most reasonable method of depreciation to adopt as a "norm" is the maximum ADR rate fully indexed for inflation.

The CMT rate established in H.R. 3838 is entirely too high -- almost 70% of the regular CIT rate. A CMT at that level ceases to be an alternative which applies only to those few taxpayers that make excessive use of so-called "preferences" and is likely to become the general rule applicable to a majority of taxpayers. The present alternative minimum tax for individuals is set at 40% (20/50) of the maximum regular rate -- a far more reasonable level. Accordingly the minimum tax rate should not exceed 15%. In addition, carryovers of ITC should be permitted against CMT liability because taxpayers may find themselves in a permanent CMT position.

The CMT proposed in H.R. 3838 is simply a parallel tax system with unrealistically slow cost recovery provisions which greatly exacerbate capital formation concerns.

Two types of firms that would be most adversely affected by this type of tax are those firms who are growing rapidly and are enjoying periods of rapidly increasing investment, or those who are presently suffering a contraction in operations and income because of a cyclical downturn. Thus, the perverse effect of the minimum tax would be to penalize most both those firms who can least afford it or those who are most likely to contribute to the economic growth of the nation. Moreover, a rate as high as that in H.R. 3838 could mean that such companies would find themselves in a minimum tax trap that could permanently penalize their investment.

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STATEMENT
of the

AMERICAN PUBLIC POWER ASSOCIATION
on

Tax-Exempt Bond Provisions of The Tax Reform Act of 1986

before the
Senate Committee on Finance

February 18, 1986

INTRODUCTION

The American Public Power Association, the national service organization representing approximately 1,750 municipal and other local publicly owned electric power systems throughout the United States, submits the following statement on the impact of the tax-exempt bond provisions of the Tax Reform Act of 1986 on public power's use of tax-exempt financing.

H.R. 3838, the tax reform bill passed by the House of Representatives on December 18, 1985, contains numerous restrictive provisions which would adversely affect all issuers of tax-exempt bonds. Under the guise of tax reform, the tax-exempt bond provisions of H.R. 3838 would impose severe restrictions on the issuance of tax-exempt bonds for the essential functions of state and local governments.

While there is a clear need to eliminate the many non-governmental uses of tax-exempt bond financing, and to ensure that any other clearly defined abuses are checked, the provisions of H.R. 3838 are so far reaching and indiscriminate that they represent a serious threat to all traditional state and local government financing, including public power, and would make such financing less efficient and more costly. Public power's operations would be restricted and its ability to operate efficiently and competitively would be weakened, resulting in higher costs for all electric consumers.

The Senate Finance Committee has an opportunity to put legitimate tax reform concerns back on track and to ensure that such reform is accomplished without gratuitous damage to necessary state and local government use of tax-exempt financing. However, this will require substantial changes in the tax-exempt bond provisions as proposed in H.R. 3838.

PUBLIC POWER

Although publicly owned electric utilities serve only about 13.4 percent of the electric meters in the United States, they are an important element in this Nation's pluralistic electric industry. They serve approximately 2,200 communities located in forty-nine states and, together with rural electric cooperatives, provide "yardstick" competition for the dominant investor owned utilities.

Public power is a traditional public purpose issuer of tax exempt bonds. Community owned electric utility systems date back to the inception of central station electric service in the early 1880's, and many public power projects predate school, water and sewage service in their localities.

In recent years, many small public power systems have joined together to form "joint action agencies." These agencies often are formed to plan and build efficient size power plants to meet the projected needs of their members. Joint action agencies also accomplish this sometimes by buying a share of a plant owned by an investor owned utility or a rural electric cooperative. Over the past decade, thirty-two joint action agencies have issued tax-exempt bonds to finance electric power supply programs serving over 700 communities in twenty-five states.

The joint action strategy is intended to give small public power systems direct ownership control over their power supply costs, the major operating cost of an electric distribution system. In many instances it has enabled public systems to break free of dependence upon large investor owned utility wholesale power suppliers and, thereby, rendered them less vulnerable to takeover attempts by those suppliers. In short, the joint action strategy has served to strengthen pluralistic ownership forms in the U.S. electric utility industry.

Finally, public power systems are actively involved, together with other segments of the utility industry, in the design and construction of transmission lines to make the maximum use of a limited resource. Because of land use and environmental factors, the number and location of transmission lines is limited. These factors, together with the public's interest in receiving a reliable source of power at the lowest possible cost, frequently dictate that transmission capacity be shared among public and private users. As a result, a complex integrated transmission grid has been constructed in this country, which enables public, private and cooperative utilities to exchange surplus or lower cost power with systems that face a temporary energy shortage, or that can meet consumer demand only at considerably higher cost.

PROBLEMS WITH H.R. 3838

The 10%/$10 million rule. Under this proposal, the interest on obligations issued by a State or local government would be taxable if more than the lesser of 10% of bond proceeds or $10 million were "used" in a trade or business by any person other than a State or local government. It is not entirely clear what constitutes "use," but it appears that it may include all output sold under contracts which differ from the service terms available to the general public.

Because the electric utility industry is the most capital intensive of industries, and because the scale and cost of facilities is so large, the $10 million half of the 10%/$10 million formula will be the effective limit under which public power projects will operate. Because of this, in fact, the effective percentage limit will be substantially less than 1%. The nominal 10% limit would undermine many of today's joint arrangements; a limit of less than

1% would destroy the ability of public power to enter any such arrangements with other utilities. This change would severely restrict the flexibility of public power systems to construct or acquire economically scaled electric generating facilities in advance of their need for the full output of such projects. Many of the economically beneficial joint action agency projects of the past fifteen years would have been hampered and made more costly, or been precluded entirely, if this proposal had been in effect. Further, as discussed below, H.R. 3838 imposes a state volume cap on the amount of tax-exempt bond proceeds which may benefit a non-exempt entity. If there must be a dollar cap to accompany a percentage limitation, it should be many times larger than the proposed $10 million. This is true because electric facility projects costing under $100 million are the exception rather than the rule.

Under current law, publicly-owned electric power systems may issue tax-exempt obligations to finance the construction of generation, transmission, and distribution facilities, or to purchase an ownership share of such facilities in joint arrangements with nonexempt persons. Public power systems may also enter into contractual arrangements whereby nonexempt parties agree to take or pay for a portion of the output from a facility financed by the public system. Typically, these private parties may be investor owned electric utilities, rural electric cooperatives, or large industrial customers. However, the portion of the output that the public system may sell to nonexempt parties over the life of the bond issue is limited to 25 percent.

The ability of a publicly owned utility to sell some of the output of a plant during its early years of operation allows the utility to provide for expected growth in its own power needs in an efficient manner. For example, for a utility estimating its power supply needs for 1995, prudent planning necessitates that it construct facilities that will provide more than enough power for its system in 1986 or 1990. This type of planning is traditional in the electric utility industry, and economically imperative for facilities that have relatively long lead times. Selling excess capacity that is available during the early years of operation of a new facility allows utilities to take advantage of the economies of scale inherent in electric generation and maximize the efficient use of the nation's electric energy system.

The proposed 10%/$10 million limit is arbitrary and ignores the basic economic and technical realities of providing electric energy from publicly owned facilities. Electric power plants take from five to twelve years to build and come into service in relatively large increments. While the demand for electric power in a utility's service area may grow at an annual rate of 2 to 3 percent, it is generally impractical and inefficient to add electric generating facilities at this rate.

This is not unique to the power industry, but it is intensified by the large scale and long life of the most efficient generating units. Any industry planning capacity additions based on projections of future needs will construct larger facilities than necessary for its immediate needs. Faced with excess capacity in the short-run, prudent managers will try to minimize the amount of unused plant. In the electric power industry, managers do this by selling the excess output in the early years. This prevents resources from remaining idle and lowers the cost of electric power to all consumers. The 10%/$10 million limit would virtually eliminate this practice for publicly owned electric systems.

The 10%/$10 million limit, as it applies to public power, is also contrary to the objective of eliminating anti-competitive and distortive effects on the economy. Publicly owned electric utilities provide the major source of competition to the dominant, investor owned utilities in the electric power sector of the economy. Publicly owned utilities provide an effective benchmark against which to compare the performance of the much larger investor owned systems. H. R. 3838 would not impose new restrictions on investor owned utilities comparable to the 10%/$10 million limit imposed on public power.

While the current limit of 25% of output that may be sold to non-exempt parties encompasses only take-or-pay or similar "output" type contracts, H.R. 3838 defines "use" in such a way as to suggest that all contract sales would be included under the proposed 10%/$10 million limit. This would mean that all sales to large commercial and industrial customers that might be made under contract terms different from the way electric service is available to the general public would be included under the limit. Under such a rule, no small utility could prudently bid to serve large customers. It would be foolish and dangerous for a small utility to make capital expenditures in order to serve a large customer absent a contractual commitment by that customer. This interpretation of "use" would constitute yet another impediment to the continued competitiveness of publicly owned utilities since there would be no similar restrictions placed on investor owned utilities and rural electric cooperatives. Sound fiscal management demands that a utility have some guarantee that a large new customer will use, or otherwise pay for, substantial plant additions demanded by it. Current law allows utilities to enter into "take or pay" contracts if the demand of each customer is de minimis (less than 3 percent), or if total contracted demand does not exceed 25 percent. Under H.R. 3838, however, a publicly owned utility could not require such contracts and be assured that a single customer's use or an aggragation of such uses would comply with the bill's limits. As circumstances change, the tax exempt status of bonds issued for this utility's projects would remain in jeopardy. Without the availability of tax exempt financing, an important incentive for large customers to locate within a public power community would be removed. Instead, utilities will have to rely on less binding arrangements or refuse to build a plant to serve the prospective customer's load.

To illustrate the broad range of problems caused by the 10%/$10 million rule, consider the following examples of the potential negative impact of this proposal:

--Eugene, Oregon; Austin, Texas; Seattle, Washington. Local governments, including publicly owned utilities, are actively pursuing energy conservation programs to reduce the need to make substantial capital investments in generating facilities. These programs include providing residential and commercial customers with weatherization materials, or offering loans, grants and rebates allowing them to purchase other conservation devices. Certain public power communities such as Eugene, Oregon, and Seattle, Washington, have used tax exempt bonds to finance these programs. Recently, voters of Austin, Texas, approved a tax exempt bond issuance expanding considerably the city's energy conservation program. The city's program has already saved over 50 megawatts of peak electrical demand at a cost of $300 to $700 per kilowatt, compared with the $1,200 per kilowatt of coal-fired generating plant. If H.R. 3838 is enacted, Austin would no longer be able to proceed with this bond issuance. Instead, the city would have to fund efficiency improvements with revenues at approximately five times the cost of the bond issuance, or else incur an even greater expense of building new power plants. Given the considerable economic benefits which Austin and other public power communities could derive from these programs, the tax exempt financing of such programs should not be jeopardized by the artifical restraints of H.R. 3838.

--Southern Minnesota Municipal Power Agency ("SMMPA"). SMMPA, a joint action agency serving 21 Minnesota public power communities, is examining the feasibility of joining with Manitoba Hydro to exchange power on a seasonal basis. This project would require SMMPA to build certain transmission facilities. SMMPA estimates that the total cost of these facilities, assuming tax-exempt bond rates of 9.25% and taxable rates of 10.525%, would rise nearly $17 million if H.R. 3838 were enacted.

--Lower Colorado River Authority ("LCRA"). LCRA is a Texas public power system which sells power at wholesale to municipally and cooperatively owned utilities. The Authority plans to issue $1.5 billion in tax exempt bonds over the next seven years to finance construction of 2 lignite plants. Applying the $10 million limit, only .66 percent of the output of these facilities could be sold to its rural electric cooperative customers using tax exempt financing.

--Austin, Texas Electric Department. Austin plans to issue $950 million in bonds over the next six years to meet its system's capital needs. At the same time today, this public power system's largest industrial customer, Motorola, is providing $7 million in revenues or nearly two percent of its total revenues. A question may arise in the future over the extent to which the utility can continue to provide power to Motorola without violating the $10 million limit.

--Intermountain Power Agency ("IPA"). IPA is a joint action agency comprised of 23 Utah municipal utilities which are investing $4.7 billion in two coal-fired power plants. A limited portion of the output of these facilities will be sold to six rural electric cooperatives and one private utility. Again, if the $10 million were in place, the effective percentage rate here would be .2 percent.

--Municipal Electric Authority of Georgia ("MEAG"). MEAG is a joint action agency comprised of 47 Georgia public power systems who are participating with Georgia Power in the construction of several plants. MEAG's financing of its Project 1 totals $2.7 billion and, in the early years of this facility, much of the output of the plant is being sold to the private utility in compliance with the 25 percent rule. In marked contrast, if the $10 million limit were in place, less than one-half of one percent could have been sold to the private utility.

Reducing the viability of publicly owned utility operations would lessen competition in the industry and foster the distorting effects of monopoly power. Such a result is intensified by other parts of H.R. 3838 which would continue many of the tax subsidies to investor owned electric utilities, and thereby enhance their economic power.

The goal of tax reform would not be served by applying the 10%/$10 million limit and its artificial and unrealistic definition of "use" to public power bonds and other traditional public purpose tax-exempt financing. In the case of public power, the current 25 percent limit has proven sufficient to prevent abuses and, at the same time, allows the efficient construction and operation of facilities.

State Volume Caps. H.R. 3838 contains a system of state volume caps that would apply not only to nonessential function bonds, but also to general obligation and essential purpose revenue bonds, including in some instances, electric revenue bonds. If non-governmental "use" (as broadly defined in H.R. 3838) exceeds $1 million, but does not violate the 10%/$10 million limit, it is still subject to a state volume cap. This provision would require many public power entities to compete for allocations under their state's or states' volume caps. Under such a chaotic system, long-range planning would be rendered impossible since capital expansion plans would be subject to the political vagaries of the allocation competition. Obtaining an allocation for facilities that might serve some out-of-state users (a commonplace in today's integrated electric utility industry) could become especially difficult; for example, the Sam Rayburn Municipal Power Agency in Texas could experience such difficulties because it not only serves communities in that state, but also one in Louisiana.

Arbitrage and Early Issuance Rules. Under current law, publicly owned utilities are permitted to take advantage of arbitrage opportunities under specific, limited conditions. The revenues provided by arbitrage are used to reduce the costs of constructing energy facilities and thereby lower electric rates to consumers. The H.R. 3838 arbitrage proposals would increase the financing costs of publicly-owned power suppliers by restricting their ability to earn legitimate arbitrage. It would require the rebate to the Treasury of all investment income earned in excess of the average coupon on a particular bond issue, with no allowance for the recovery of reasonable costs of issuance. The rebate requirements are complex, and would be particularly onerous for the many very small essential purpose bond issuers.

There is no practical point in making arbitrage rules so restrictive that the arbitrage earnings foregone simply result in larger sized bond issues at greater cost. It makes no sense to increase the volume, expense and complexity of bond issues when it is questionable whether there would be a net benefit to the Treasury.

In addition, the proposal ignores fundamental practicalities of financing long-term construction projects efficiently. Conventional power plants can take from 5 to 12 years to build, and it is inherently inefficient and totally unreasonably to--as the proposal would require--spend 5% of bond proceeds within 30 days of issuance and all bond proceeds within three years. Such a restriction would result in multiple issues for long-term construction projects, with attendent higher issuance and administrative costs. This would be grossly inefficient and impractical in the case of a simple homebuilder, let alone the multi-million dollar, multi-year construction of a project as complex as an electric power plant.

Publicly owned utility financial managers would be limited in exercising their professional judgment in the structuring and timing of bond sales. The efficient size of a particular bond issue depends on factors such as the total cost of a project, the length of construction time, current and expected interest rates, issuance costs for various volumes, and other factors. Public power financial managers would be effectively precluded from considering these factors. Instead, they would be tied to arbitrary and unrealistic criteria of spending a significant amount of the proceeds over short time periods that have no relation to the size and construction schedules of projects.

Whatever ones purpose, arbitrage restrictions which limit and/or require that arbitrage earnings be rebated to the Treasury would seem to be sufficient without the additional stricture of the proposed early issuance requirements. That such layered penalties should be proposed for essential purpose tax-exempt bonds suggests not merely an intention to reform, but a determination to harass.

Advance Refunding. The House bill would restrict the number and amount of advance refundings of many public power bonds and prohibit the advance refunding of some issuances. These proposals would severely restrict a publicly owned utility's ability to efficiently manage its debt--the way other enterprises do--to lower costs to consumers. They would limit an issuer's ability to take advantage of lower interest rates, to restructure debt service to match a changing revenue stream, or to mitigate the effects of an overly restrictive bond indenture. In short, they would seriously impair an issuer's ability to exercise sound financial management.

Advance refundings do temporarily increase the volume of tax-exempt bonds outstanding, but they can also substantially contribute to an issuer's financial soundness. The attempt to reduce the volume of tax-exempt bonds by eliminating advance refunding undermines local government's right to issue tax-exempt bonds, and the basic economic benefits they derive from them. Taking away a publicly owned utility's ability to manage debt efficiently adds significantly to financing costs and strikes at the very heart of the right to use tax-exempt financing.

Current law prohibits the advance refunding of IDBs. If there are additional private purpose tax-exempt bonds that should be similarly restricted, it may be appropriate to change existing law for that purpose. H.R. 3838, however, goes beyond the objective of restricting private uses of tax-exempt bonds and attacks essential public purpose financing. There is no justification for changing existing law as it applies to the advance refunding of governmental purpose bonds issued by public power entities.

Reporting Requirements. The proposal would extend to all tax-exempt bonds the IDB reporting requirements of current law. Should issuers fail to file reports, the bonds would lose their tax exemption. This proposal would be both burdensome and unnecessary. A reporting requirement designed to police the issuance of private purpose industrial development bonds is totally inappropriate for public purpose obligations and is in no way related to the stated goal of tax reform.

Effective Date. The bond market disruption caused by H.R. 3838's January 1, 1986, effective date for its tax-exempt bond provisions is an example of dereliction of legislative responsibility. The uncertainty and additional costs imposed upon state and local governments by what remains, not law, but merely an ill-considered proposal, is inexcusable. While this problem has been created by the House, we urge the Committee to acknowledge the seriousness of the situation and work to bring about a speedy solution.

Other Provisions. H.R. 3838 establishes an important precedent which could erode the tax exempt status of state and local government bonds. Under the bill's individual and corporate alternative minimum tax provisions, interest income received from "nonessential" government bonds would be taxable. This requirement ignores the fact that many of these facilities are government owned and operated. Moreover, property and casualty insurance companies will be taxed on a limited amount of interest income received from all government tax exempt bonds in their portfolios. These changes will make it more difficult to market tax exempt bonds and, ultimately, could raise interest costs for state and local government borrowers.

CONCLUSION

Private entities should not benefit unreasonably from tax exempt financing; however, H.R. 3838 goes far beyond that limit by placing government agencies in a planning "straight jacket." Public power systems will face rigid limits dictating their use of tax exempt financing while trying to compete with private power companies who will still retain significant tax advantages. Public power systems will not be able to make long-term commitments to participate in any joint projects, even within the bill's limits, because of uncertainty from one year to the next over receiving a state volume cap allocation. Public power systems will not be able to assist their communities in attracting new industries because of the risk of losing their bonds' tax exempt status. In short, artificial tax code considerations, and not sound energy practices, will drive public power systems to build inefficiently sized plants or duplicate transmission lines to avoid the financial consequences of losing their tax exempt status.

We urge the Committee to disregard the tax-exempt bond provisions of H.R. 3838 and adopt current law as a point of departure for consideration of reform. Abuses of tax-exempt bond financing should be corrected. This can be done without joining the attack on the legitimate use of such financing by state and local governments for traditional public purposes.

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February 7, 1986

Attn: Betty Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Bldg.
Washington, D. C. 20510

Dear Senator Packwood:

I would like to personally join forces with the National Association of Manufacturers in urging you to set aside tax reform for now, and turn your attention to the nation's twin problems of deficit spending, and trade.

I believe that the House version of the Tax Reform Bill, H.R. 3838 that is now before your committee for consideration is irreparably flawed and the bill as it exist should not be considered.

We hope you will include this letter in the written hearing records as part of your Senate Finance Committee hearing and consider setting aside tax reform at this time to concentrate on our two, in my opinion most, most serious problems.

Sincerely,

ANDERSON CHEMICAL COMPANY

Jet Anderson

R. K. (Jet) Anderson
President

RKA:mn

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ARIZONA STATE
UNIVERSITY
TEMPE, ARIZONA 85287

FEB 25 1986

The Honorable Bob Packwood, Chairman
United States Senate Finance Committee
207 Dirksen Building
Washington, D.C. 20510

Dear Senator Packwood:

H.R. 3838, the "Tax Simplification Act of 1985", as passed by the House of Representatives and referred to the Senate Finance Committee, contains a number of provisions that would, if included in the final version of tax reform legislation, adversely affect colleges and universities and their faculty and staffs. As we understand it, the sections in the bill passed by the House of Representatives were not proposed by the President, but were included in the bill by the House Ways and Means Committee.

Overview of H.R. 3838 Provisions That Affect Retirement Plans. Among the most important of these provisions are probably those that affect the retirement laws that apply to university faculty and staff. The major changes in H.R. 3838 are:

--the amount that a university faculty and staff member may annually contribute to tax sheltered annuities (TSAs) would be decreased from the current level of 20% of salary, up to $30,000, to $7,000. Any TSA contributions would reduce, dollar for dollar, the contribution that university faculty and staff may contribute to an IRA;

--the purposes for which withdrawals of contributions to tax sheltered annuities could be made would be limited and additional restrictions and penalties would be imposed on withdrawals;

--certain "non-discriminatory" tests would be applied to all university retirement programs; and

--the existing tax exemption for TIAA/CREF would be revoked.

A discussion of each of these and our concerns follows.

Reduction in Tax-Deferred Annual Retirement Contributions. An example best displays the adverse effect that the new limits would have on a faculty member's retirement planning

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and taxes. Assume that an Arizona State University faculty member's salary is $40,000; this salary level is approximately that of a full professor. Currently, that faculty member could contribute $8,000 each year to a tax deferred retirement plan; in addition, the faculty member could contribute $2,000 annually to an IRA. Thus, total tax deferred contributions toward retirement would be $10,000 annually.

If H.R. 3838 becomes law, only $7,000 could be contributed annually on a tax deferred basis. As we understand it, if the individual has a TSA and contributes as much as $2,000 to the TSA, no amount could be set aside in an IRA. In effect, an individual would be prohibited from having both an IRA and a TSA. If the individual in the example is at the 33% marginal tax bracket, then the additional taxes -- compared to those under current law -- would amount to just under $1,700 a year.

The result of higher taxes and less retirement income when a faculty member retires seems to go against the objectives of making our retirees less dependent on Social Security. Moreover, the proposals can be classified as "anti-savings" and "anti-investment"; as such, they are economically counterproductive at a time when savings and investment need to be encouraged.

At Arizona State University, over 1,200 faculty and staff members, or 26%, currently have TSAs; they could be adversely affected by these provisions. These individuals participate in plans offered by 33 companies. We support continuing present law that allows tax deferred retirement contributions up to 20% of salary and IRAs. In all events, the proposed $7,000 annual cap is too low.

Withdrawals From Tax Deferred Plans. H.R. 3838 would also limit the purposes for which withdrawals before age 59 1/2 could be made from contributions to retirement accounts. Currently, there are no significant limits.

If the Senate accepts the House-passed version, withdrawals would be prohibited before age 59 1/2 except for separation from service, financial hardship, death or disability. A 15% penalty tax would be applied for withdrawals for financial hardship or separation from service. The proposed penalty appears to conflict with the purpose of allowing withdrawals; it has the ironic result of penalizing those most in financial need through a special tax.

In addition to the prohibitions and penalty, H.R. 3838 would require distributions to begin at age 70 1/2, regardless of the actual retirement date. A 50% excise tax would be imposed on the amount that should have been distributed, but was not, as an incentive to assure distributions. In concept, these provisions conflict with the Federal laws that prohibit discrimination against the aged, e.g., forced retirement. The provisions in H.R. 3838 would force those who have delayed a career and began saving for retirement late in life, e.g., married women who may have stayed out of work to raise children, to pay taxes on funds that they are attempting to accumulate toward a decent retirement.

Non-Discrimination Requirements for Retirement Plans. The House-passed bill would also require universities to assure that their plans met complicated "non-discrimination" requirements. As the American Council on Education has pointed out:

> "In the absence of evidence that a substantial problem of discrimination exists in college pension plans, college budgets should not be heavily and unnecessarily burdened with inside administrative costs and outside legal, actuarial and accounting expenses in order to prove comparability to the Internal Revenue Service on a continuing basis and to possibly restructure retirement plans. Application of the existing comparability tests to the multiple and widely varied retirement structures that exist at many educational institutions could, we think, simply result in saddling colleges with large unproductive administrative costs."

We believe that the provisions in H.R. 3838 on "non-discrimination" are unnecessary and expensive. They represent unneeded complexity in our tax laws and redound to the benefit of accountants and attorneys whose services would be required. At the same time, the benefits of the retirees for whom the plans were developed would be reduced by these unnecessary expenses.

TIAA/CREF Taxes. H.R. 3838 would repeal the existing exemption from Federal taxes the TIAA/CREF enjoys. Again, as the American Council on Education has pointed out:

> "The imposition of a proposed tax on the TIAA/CREF pension system, as currently structured, would have the immediate effect of reducing the TIAA retirement income of 150,000 retirees and the pension benefits arising from past and future contributions to TIAA for 850,000 participants accumulating benefits. The impact on CREF retirement benefits could also be significant."

As a practical matter, H.R. 3838 would probably merely require TIAA/CREF to reorganize in a way that would permit it to retain its tax exempt status. It would, however, have to undergo the needless administrative and legal costs of such a reorganization with the resulting costs and loss of income to participants.

We understand the need to make the tax laws more equitable. Nevertheless, we believe that -- for the reasons set out above -- the provisions in H.R. 3838 affecting the retirement benefits of faculty and staff at colleges and universities are inappropriate ways to achieve these objectives. These provisions could adversely affect our ability to compete with the private sector for qualified faculty and staff. The private sector, of course, has significantly more flexibility to affect any changes in retirement laws. We strongly recommend that the Senate Finance Committee amend the House-passed bill to retain the current laws regarding tax-sheltered annuities.

We appreciate the opportunity to submit written comments and we hope they are helpful to the Committee.

Sincerely,

J. Russell Nelson

J. Russell Nelson
President

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ARTHUR ANDERSEN & CO.

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December 9, 1985

Mr. David Brockway
Chief of Staff
Joint Committee on Taxation
Longworth House Office Building
Room 1015
Washington, D. C. 20515

Mr. Robert J. Leonard
Chief Tax Counsel
Committee on Ways & Means
Longworth House Office Building
Room 1136
Washington, D. C. 20515

Mr. Kenneth J. Kies
Minority Tax Counsel
Committee on Ways & Means
Longworth House Office Building
Room 1106
Washington, D. C. 20515

Gentlemen:

Enclosed is a copy of an analysis we have prepared, comparing certain aspects of the Ways & Means Committee tax reform bill to the Republican Alternative for individual taxpayers. Relevant assumptions made in preparing this comparison are attached.

Because various tax reform proposals have many differences relating to rate structure, taxable income, allowable deductions and personal exemptions, it is difficult to make comparisons. Indeed, a comparison that takes into account all of the nuances of these differences is prohibitively complex. Nevertheless, it can be instructive to consider the impact that alternative tax reform proposals would have on hypothetical individual taxpayers, even if the assumed facts are not complex. The enclosed analysis attempts to make this comparison, although in a very limited fashion, i.e. restricted only to married individuals filing joint returns who might be expected to itemize their deductions.

We have not made a similar comparison of the Committee bill and the Republican Alternative for other types of taxpayers, e.g. single taxpayers, heads of households or nonitemizers. Furthermore, we have not made comparisons of the two proposals that reflect differences that might arise, for example, in computing adjusted gross income or the alternative minimum taxable income. It would obviously be necessary to make such comparisons, as well as to examine other differences affecting business, international trade and capital formation, before drawing conclusions as to the relative merits of the two tax plans.

We would be pleased to answer any questions you might have concerning this analysis.

Very truly yours,

ARTHUR ANDERSEN & CO.

By Stephen R Corrick
Stephen R. Corrick

DAK

Enclosures

COMPARISON OF TAXABLE INCOME AND TAX DUE FOR REPUBLICAN ALTERNATIVE AND WAYS & MEANS BILL
WITH RESPECT TO A CALENDAR YEAR JOINT RETURN IN 1987

ITEMIZED DEDUCTIONS: 20% AGI
INFLATION INDEX: 4.35%

			ITEMIZED DEDUCTIONS ALLOWABLE AFTER STANDARD		TAXABLE INCOME		TAX DUE	
FAMILY SIZE	INCOME LEVEL	TOTAL ITEM. DED.	W&M BILL	REPUBLICAN ALTERNATIVE	W&M BILL	REPUBLICAN ALTERNATIVE	W&M BILL	REPUBLICAN ALTERNATIVE
4	20,000	4,000	0	0	6,620	6,620	993	993
5	20,000	4,000	0	0	4,530	4,530	680	680
6	20,000	4,000	0	0	2,440	2,440	366	366
7	20,000	4,000	0	0	350	350	53	53
4	25,000	5,000	0	0	11,540	11,540	1,731	1,731
5	25,000	5,000	0	0	9,450	9,450	1,418	1,418
6	25,000	5,000	0	0	7,360	7,360	1,104	1,104
7	25,000	5,000	0	0	5,270	5,270	791	791
4	30,000	6,000	0	338	16,460	16,460	2,469	2,469
5	30,000	6,000	0	338	14,370	14,370	2,156	2,156
6	30,000	6,000	0	338	12,280	12,280	1,842	1,842
7	30,000	6,000	0	338	10,190	10,190	1,529	1,529
4	35,000	7,000	120	1,145	21,380	20,695	3,207	3,104
5	35,000	7,000	0	1,145	19,290	18,605	2,894	2,791
6	35,000	7,000	0	1,145	17,200	16,515	2,580	2,477
7	35,000	7,000	0	1,145	15,110	14,425	2,267	2,164
4	40,000	8,000	1,120	1,951	25,720	24,889	4,082	3,874
5	40,000	8,000	600	1,951	24,150	22,799	3,690	3,420
6	40,000	8,000	80	1,951	22,120	20,709	3,318	3,106
7	40,000	8,000	0	1,951	20,030	18,619	3,005	2,793
4	45,000	9,000	2,120	2,758	29,720	29,082	5,082	4,922
5	45,000	9,000	1,600	2,758	28,150	26,992	4,690	4,400
6	45,000	9,000	1,080	2,758	26,580	24,902	4,297	3,878
7	45,000	9,000	560	2,758	24,750	22,812	3,890	3,422
4	50,000	10,000	3,120	3,564	33,720	33,276	6,082	5,971
5	50,000	10,000	2,600	3,564	32,150	31,186	5,690	5,449
6	50,000	10,000	2,080	3,564	30,580	29,096	5,297	4,926
7	50,000	10,000	1,560	3,564	29,010	27,006	4,905	4,404
4	75,000	15,000	8,120	7,330	53,720	54,510	11,767	11,280
5	75,000	15,000	7,600	7,330	52,150	52,420	11,418	10,757
6	75,000	15,000	7,080	7,330	50,580	50,330	10,868	10,235
7	75,000	15,000	6,560	7,330	49,010	48,240	10,319	9,712
4	100,000	20,000	13,120	11,040	73,720	75,800	18,767	18,236
5	100,000	20,000	12,600	11,040	72,150	73,710	18,418	17,713
6	100,000	20,000	12,080	11,040	70,580	71,620	17,868	17,191
7	100,000	20,000	11,560	11,040	69,010	69,530	17,319	16,668

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ASSOCIATION OF BRITISH INSURERS

ALDERMARY HOUSE, QUEEN STREET, LONDON, EC4N 1TT
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Excise Tax on Insurance Premiums Paid to Foreign Insurers and Reinsurers

The Association of British Insurers (ABI) offers the following comments on the House of Representatives' proposal to amend the Federal Excise Tax ("FET") on foreign insurance. We respectfully request that these comments be made a part of the record of the hearings conducted by the Senate Finance Committee on January 29-30 and February 3-5, 1986. The ABI is a trade association comprising 424 life and casualty companies, representing approximately 80% of the UK insurance market.

A. Present Law. Present law imposes an excise tax (subject to certain exemptions) on any insurance transaction with a foreign insurer if the transaction involves the insurance or reinsurance of a US risk. The income tax treaty between the US and UK expressly provides an unconditional waiver of the FET.

B. House of Representatives Provision. H.R. 3838, the "Tax Reform Act of 1985," would convert the unconditional waiver in the UK treaty into a "conditional" waiver. The House provision would tax the UK insurer on a transaction now wholly exempt under the treaty, if the UK company later reinsures a policy covering any US risk to a reinsurer from a non-exempt country. The reinsurance arrangements of a UK company are to insure that company and are not the reinsurance of US risks.

In addition, the House provision would: (i) require the US broker or insured responsible for transmitting premiums to withhold the tax, thereby causing the exempt insurers to apply for a refund; and (ii) increase the rate on reinsurance of US casualty risks from one percent to four percent.

C. Unilateral Abrogation of US/UK Tax Treaty. The Committee stated that the excise tax provision does not violate the US/UK tax treaty because the exemption is continued for the payment of premiums to UK companies, and such premiums are only taxed if the UK company subsequently reinsures any part of those policies to a non-exempt third party reinsurer. The reinsurance of US risks theory is not accepted by UK insurers. This strained legal interpretation of an unconditional treaty exemption violates both the language and the legislative history of the US/UK tax treaty. The Committee's argument looks behind the transaction, and beyond the borders of the US. It creates an unprecedented and unadministrable burden on UK insurers to become revenue agents for the IRS.

The Senate Foreign Relations Committee Report explanation of the US/UK Double Tax Treaty states unequivocally that:

> No US excise tax will be collected if the UK insurer has no US trade or business, regardless of whether or not it reinsures the risk. (Emphasis added). S. Exec. Rep't. No. 96-5 at 8.

Moreover, the IRS and the courts have never extended the tax to secondary reinsurance transactions. The tax has only been applied to outbound transactions which originate in the US.

D. No Evidence of Abuse. The Committee Report erroneously asserted that, under present law, reinsurers in non-exempt third countries may obtain a substantial part of the exconomic benefit of the US/UK treaty excise tax waiver. We understand the Committee's proper concern about "treaty shopping" or the intentional use of treaty benefits by ineligible parties to avoid tax. This complicated provision was formulated, however, to correct a perceived abuse that all the available quantitative evidence indicates does not exist in practice.

The UK Government, at the request of Congress and the Treasury Department, expended significant resources to produce a survey of the major insurers and reinsurers in the UK. That survey was unfortunately released too late for the House or the Treasury to adequately review its findings prior to the mark-up of H.R. 3838. Even the Committee acknowledges, however, that the survey data can be interpreted to suggest that "third-country reinsurers generally do not affirmatively initiate large 'back-to-back' facultative insurance transactions involving US risks through UK conduit entities." In simpler words, the evidence indicated that the abuse of greatest concern to the House does not exist in the UK insurance market.

The Committee Report has implied that the UK Government has not considered the possibility that numerous individual contracts for US risks may be reinsured in the aggregate with non-exempt insurers. A special study was made by the UK Department of Trade and Industry, which regulates UK insurers, of the 1984 returns for non-life business of the sample of companies participating in the earlier study. This study found no evidence that substantial proportions of their reinsurance were placed with individual reinsurers in non-exempt countries. In short, there is no evidence of collusion with non-exempt insurers to reinsure large numbers of US contracts in the aggregate.

A second conclusion substantiated by this study and a subsequent UK analysis, which the House Report notably failed to acknowledge, is that economics and UK Governmental regulation already preclude a non-exempt third party insurer from using a conduit entity in the UK to avoid the US FET. The UK company must assume substantial insurance liabilities in the tax avoidance transaction described by the Committee for a savings of the FET which is nominal, by comparison. A detailed analysis balancing the minimal amount of tax savings versus the high level of additional liability assumed by the fronting company conclusively demonstrates that such a tax avoidance mechanism would be economically disadvantageous to a UK insurer or reinsurer.

A memorandum by the UK Department of Trade and Industry, recently submitted by the UK Government, explains in detail that UK legislation would inhibit the establishment of a "fronting" company to serve as a conduit to a non-exempt reinsurer. Moreover, the solvency margin requirements would discourage existing companies from "fronting."

An additional study was submitted to Treasury which reviews US reinsurance placed with foreign countries, using data collected by the US Department of Commerce (no comparable data is available from the UK). If the abuse described in the Committee Report were prevalent, we would expect that there would have been a significant increase in placements into the UK after the treaty's ratification. That data demonstrates that (i) the rate of increase in the US reinsurance ceded to the UK has been significantly less for the four-year period after the treaty's ratification in 1980 than for the five-year period before, and (ii) the rate of growth for the UK in the four-year period after the treaty's adoption has been less than for any other country, except the Latin American Republics, for which data is reported by the Department of Commerce. These findings support the conclusion that the unconditional waiver in the UK treaty has not provided an incentive to place reinsurance with the UK in order to avoid the tax.

E. Proposal in Unadministrable. Compliance with this provision would require a British company to trace US risks through complex reinsurance arrangements and then to allocate reinsurance premiums covering aggregate risks to single contracts. Such a procedure is not part of current industry practice. Policies are reinsured typically in a block by product line that can include hundreds of thousands of individual policies. The locations of the covered risks in each policy are generally not identified. For instance, a product liability policy for a multinational chemical manufacturer may insure against risks in every country in which the chemical products are sold. Such a procedure would require the development of new and very costly systems for US business. Making these computations at the time a contract is written would be impossible. This difficulty in tracing reinsurance of US risks was a primary motivation for negotiating an unconditional excise tax exemption in the US/UK tax treaty.

Finally, given the experience of British companies in obtaining a refund of the excise tax for the 5-year period between the treaty's ratification (1980) and effective date (1975), British companies have good reason to be sceptical of the effectiveness of a refund procedure. Neither direct compensation nor a sense of obligation derived from ongoing business relationships proved sufficient to ensure accuracy in brokers' returns, and British companies believe the amount they received was far less than the full amount due.

The refund procedure would inevitably deprive British companies of the use of the funds withheld for several years. The allocation of reinsurance premiums could not be made until the year end and would require several months, at a minimum. If the US Government required audits of returns, as it did previously, refunds might be delayed even further.

The amount withheld - 4% of gross premiums - is substantial and could make the difference between profitable and unprofitable experience on business. Under the Committee's proposal, the entire amount due could be withheld because the amount reinsured would not be determinable at the time the insurance is written. The loss of investment return on these funds would not be made up by a simple refund of the tax.

F. Capacity Shortage Would Increase. US insurers are currently experiencing a widely publicized capacity shortage which restricts the amount of risk they can insure. Reinsurance from the UK enables US companies to reduce and diversify their level of risk and allows them to write new business. It would be contrary to US policyholders' interests to adopt a measure which would deter British companies from writing or reinsuring US business, or would indirectly contribute to an increase in existing rates.

G. Conclusion. The UK Government has more than adequately demonstrated that the example of abuse provided as the rationale for the amendment is not justified. Before legislating burdensome and costly new administrative requirements applicable to the UK insurance industry in abrogation of US treaty obligations, it is reasonable to suggest that the Senate should request the Treasury or Joint Committee to demonstrate a need for such a change. In the absence of clear and convincing proof of abusive transactions, we request that the provision be amended to preserve the unconditional waiver of the excise tax in the US/UK treaty.

We appreciate your consideration of these issues.

Respectfully yours,

K E Loney

K.E. Loney
Manager, Taxation and Accountancy

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Agmc
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BOARD OF DIRECTORS
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STATEMENT OF

THE ASSOCIATION OF GENERAL MERCHANDISE CHAINS, INC. (AGMC)

TO

COMMITTEE ON FINANCE

UNITED STATES SENATE

ON

COMPREHENSIVE TAX REFORM

FEBRUARY 20, 1985

. . . the national organization and unified voice for chain store retailers

The Association of General Merchandise Chains, Inc. (AGMC) submits this statement for the Committee's record in its hearings on comprehensive tax reform. AGMC hopes that comprehensive tax reform will be enacted during 1986, and supports fundamental reform of the Federal income tax system, with the goal of making the tax system more equitable for all corporations and individuals in the United States.

AGMC represents the nation's pricecompetitive general merchandise retail industry. AGMC's membership includes retail companies that operate more than 20,000 discount, variety, dollar, junior department, family center, off-price, factory outlet, catalog showroom and other general merchandise stores. These companies range in size and include many of the nation's largest retail chains as well as companies active in one or more regions of the country. AGMC member stores are located in all 50 states, and account for over $50 billion in annual sales.

On May 28, 1985, President Reagan proposed a plan for comprehensive tax reform. The President's plan seeks a transformation of the American tax system to one that is "clear, simple and fair for all." AGMC supports the fundamental restructuring of the corporate and individual income tax laws contained in the President's tax proposal, and we intend to assist in the effort to bring a greater degree of fairness to the nation's tax laws. The tax proposal is a positive step on the road to making the Federal income tax system fairer, simpler, and more equitable for retailers in particular, and for the overall business community in the United States.

In December 1985, the House of Representatives passed H.R. 3838, the 1985 Tax Reform Act. AGMC supports the restructuring of the corporate and individual income tax laws contained in the bill, and we intend to assist in the effort to bring a greater degree of fairness to the nation's tax laws. The bill is a positive first step on the road to making the Federal income tax system fairer, simpler, and more equitable for retailers in particular, and for the overall business community in the United States.

The current corporate tax system is full of inequities. To date, most capital-intensive industries are able to take advantage of tax deductions which drastically reduce their effective tax rate, while most labor-intensive industries have few deductions and pay high effective tax rates in comparison.

The result is that a significant part of the business community pays little or no taxes. Their low tax payments come at the expense of other industries. For example, according to newspaper reports comparing K mart with others, K mart Corporation had profits of $1.3 billion over the last three years, while the DuPont Corporation earned twice that amount: $2.6 billion. But under current corporate and Federal income tax laws, K mart -- a retail chain -- paid $554 million, while the twice-as-profitable DuPont -- a chemical company -- paid only $100 million in Federal income taxes. This points out the unequal tax burden that results from the differing tax breaks available to differing industries under the current Federal corporate income tax laws.

The current Federal tax system causes too many business decisions to be made solely for tax reasons, not for economic reasons. Indeed, certain industries structure their business decisions primarily to reduce their tax liability. We believe that decisions made solely for tax reasons result in economic distortions. These continual distortions weaken the United States economy, and make it more difficult for United States businesses to compete in the worldwide market.

Many provisions in the present Federal income tax system benefit industries other than retailing, even though wholesale and retail trade today constitute one of the nation's largest industries. In fact, retailing employs more people than any other segment of the economy, and employment in our industry continues to grow. Manufacturing sectors of the economy receive much more attention, and more favorable tax treatment; we believe that a fairer, more even-handed tax system would better recognize the contribution that the retailing and service industries make to the overall economy.

Retailers are encouraged by the overall design of H.R. 3838 and the President's tax plan; we believe we would be fairer to us than the present system. To us, the most important feature of the President's tax plan is the proposal to reduce corporate income tax rates. Retailers in general have a high effective tax rate resulting from our inability to take advantage of certain tax breaks available to other industries. High Federal income tax rates are particularly damaging to the significant number of small retailers.

Reducing the current top 46% corporate tax rate while retaining the graduated rate structure will reduce the existing Federal income tax disparity among differing industries. Reduced graduated corporate income tax rates will be especially beneficial to the numerous small retailers in the U.S.

AGMC supports one important feature of the House-passed bill, which reflects a change that the Administration has already made from its original proposals for corporate tax rates: the recognition that the nation's smallest businesses should not be subject to the maximum corporate tax rate. In retailing and the rest of the economy, small business is a major source of employment and innovation. By retaining a graduated rate structure for small corporations with taxable income of $140,000 and less, the Administration's present proposal takes a needed step in the right direction for smaller enterprises.

Another key aspect of the House-passed bill is the proposal for a partial dividends paid deduction. Currently, corporate profits are essentially taxed twice, since corporations pay income tax on their profits, and individual shareholders pay income tax when these profits are distributed as dividends. This double taxation discourages individuals from investing needed capital in all businesses, and particularly the retailing sector. For many retailers, their employees also are stockholers. Being both an employee and owner of a business encourages greater interest and competitiveness among employees in the retail sector. By providing partial relief from double taxation of corporation profits, individuals will be encouraged to participate via equity ownership in business enterprises.

Modification of the existing accelerated cost recovery system is another important feature of tax reform. The current system, enacted as part of the Economic Recovery Tax Act of 1981, provides accelerated cost recovery for certain types of assets, which has resulted in many non-economic incentives that acquire certain types of assets. For retailers, our investment is primarily in inventory, and only secondarily in tangible assets. As a result, most retailers have not benefitted significantly from the tax incentives the accelerated cost recovery system provides for investing in certain tangible types of assets. A revised cost recovery system, along with repeal of the investment tax credit, would reduce the disparities which the accelerated cost recovery provisions now cause among differing industries.

While enactment of the House bill would help retailing businesses, its main benefits would go to individual taxpayers -- our customers. While different individuals will be affected in differing ways by the tax reform plan depending upon their individual circumstances, overall consumers' tax burdens would be reduced by the plan's simplification of individual marginal tax brackets, reduction in tax rates, and the base-broadening restriction and/or elimination of numerous deductions and credits available under the current system. AGMC believes a less complicated tax system will be more equitable for a greater number of individual taxpayers.

Because the retailing industry is labor-intensive, it is naturally concerned about tax reform proposals impacting employer-provided fringe benefits. Other aspects of the tax reform plan affecting fringe benefits, such as employee savings and pension plans, should also be carefully considered. Encouraging employee saving and providing for employee financial needs after retirement are important considerations for employees during their working years; the tax system should not create new disincentives to retirement savings for retirement.

Overall, however, retailers support most aspects of H.R. 3838, and strongly believe the Senate should move forward now to enact meaningful tax reform this year. AGMC endorses the general thrust of the H.R. 3838, even though particular details of the plan could be improved. On its own merits, the bill has much in its favor: it would promote greater fairness among corporate taxpayers, help simplify a tax code that has grown almost beyond comprehension in complexity, and reduce tax burdens on most individuals.

The House tax reform plan is also far preferable to other approaches that some have suggested for achieving fundamental tax reform. Unlike proposals for a value-added tax, a national sales tax, consumption taxes or a surcharge on the corporate income tax, H.R. 3838 would not aggravate inflation or unfairness in the tax system, and would not harm the consuming public, particularly low- and moderate-income consumers.

AGMC particularly opposes the business transfer tax proposal, which would increase the already high tax burden on the retail industry, increase complexity, potentially negatively impact U.S. trade, and not achieve the greater fairness than would result if the current tax system is reformed.

The Administration has wisely rejected a value-added tax or a national sales tax as unworkable. There are, of course, a number of other serious drawbacks to such schemes. They are, by their very nature, seriously regressive, falling most heavily on those who can least afford to pay them. And they also build inflation deeper into the fabric of the economy.

Imposing a corporate surtax, rather than undertaking fundamental tax reform, will only accentuate the existing inequities in the Federal income tax system. AGMC believes that it is time to move ahead with reform of the present Federal income tax structure to remove the disparities inherent in the present Federal income tax law for different segments of the business community.

In conclusion, we again wish to indicate our support of the H.R. 3838. Overall, we believe that it would simplify the Federal income tax system, reduce tax complexity, and provide incentives for economic growth. The current Federal tax system discourages economic activity, and fuels taxpayer resentment. Corporate and individual rate reductions in the proposal must form the basic foundation of any tax reform legislation. The 1985 Tax Reform Act, if enacted, will provide a climate for more rapid economic growth by bringing needed fairness and efficiency to our tax system and by freeing the market to allocate investment on the basis of business sense, rather than to capture special tax breaks. The time for tax reform is now, and H.R. 3838 generally goes a long way to accomplish the needed reform of the Federal income tax system.

STATEMENT OF THE

BANKERS' ASSOCIATION FOR FOREIGN TRADE

ON THE FOREIGN TAX CREDIT

PROVISIONS OF H.R. 3838

SUBMITTED TO THE

COMMITTEE ON FINANCE

UNITED STATES SENATE

February 18, 1986

INTRODUCTION

The Bankers' Association for Foreign Trade ("BAFT") is a trade association of money-center, regional and smaller banks dedicated to promoting international trade and finance. Its 135 U.S. voting members comprise virtually all U.S. banks actively engaged in international banking and trade finance.

BAFT is submitting this statement in order to present its opposition to section 602 of H.R. 3838, the "Tax Reform Act of 1985," which section would deny U.S. banks foreign tax credits for gross foreign withholding taxes paid abroad. BAFT believes there are many compelling reasons for opposing section 602 of H.R. 3838: it is contrary to sound tax policy; it is discriminatory because it is directed solely against banks and other financial institutions subject to withholding taxes on cross-border loans; and it is unfairly retroactive. However, in this statement, BAFT would like to focus on the very damaging impact which section 602 will have (in fact, already is having) on the ability of U.S. banks to finance U.S. exports in highly competitive international markets. In this connection, BAFT's concerns with respect to section 602 apply as well to the President's proposed per country foreign tax credit limitation, which was strongly opposed last year by business and banking industry witnesses before the Committee.

THE SCOPE AND IMPORTANCE OF TRADE FINANCING

Financing is a critical competitive component in almost every export sale. Intense foreign competition and debt problems abroad generally require that foreign buyers of U.S. commodities and goods be quoted an "all-in" price that includes financing. U.S. exporters of commodities and goods have therefore turned to their U.S. bank lenders to provide this crucial financing component and to assume the associated buyer credit risk. Money-center, regional and smaller banks are meeting this need through increased emphasis on internationally competitive trade financing.

This emphasis is revealed in statistics on U.S. bank lending abroad. As of June 30, 1985, U.S. banks had $324 billion in total claims on foreign borrowers. Over 60 percent of the claims had a maturity of one year or less with the majority representing short-term credits facilitating exports. Of the total claims, $103 billion were to non-OPEC lesser-developed countries (LDCs). Of that amount, 47 percent had a maturity of one year or less.

Section 602 of H.R. 3838 and other proposals to deny U.S. banks foreign tax credits for foreign gross withholding taxes, would have seriously adverse effects on U.S. bank export financing to countries which impose such taxes -- countries which account for virtually all U.S. exports. In fact, House passage of H.R. 3838, has already caused some U.S. banks to stop export financing involving withholding tax considerations, because of the legislation's retroactive denial of foreign tax credits for gross withholding taxes.

In this statement, BAFT would like to explain how and why reduced foreign tax credits in international lending will, in turn, cause a significant reduction in private bank financing of U.S. exports.

PROPOSED CHANGES TO THE FOREIGN TAX CREDIT

Like other taxpayers, U.S. banks that engage in international activities are subject to foreign taxes on income produced from such activities and are also subject to U.S. income tax on the same income. The foreign tax credit is the tax mechanism by which relief is obtained from the double taxation of the same income that would otherwise occur.

Current law entitles U.S. taxpayers, including banks, to take a credit against U.S. taxes for taxes paid to foreign countries on income earned in those countries. The credit is calculated on an overall basis, meaning that the credit is determined by adding together all of the creditable taxes paid to all foreign countries. The credit that may be claimed, however, cannot exceed the total U.S. tax on the taxpayer's foreign source income. Thus, credits are not used to reduce U.S. tax on U.S. income.

Fifty foreign countries impose gross foreign withholding taxes on interest paid to lenders outside the country. See Exhibit A. The United States also imposes such a tax. When a U.S. bank extends credit to a buyer in one of these countries to purchase U.S. commodities or goods, the bank becomes liable for payment of the withholding tax.

Under current U.S. tax law and regulations, U.S. banks are able to take a foreign tax credit for gross withholding taxes paid on interest which they receive or accrue. This availability of a credit prevents double taxation of the same income and gives U.S. banks the same right as other U.S. taxpayers to include such withholding taxes in their overall tax credit limitation. While taxation systems differ among countries, the present U.S. foreign tax credit for withholding taxes is comparable to the treatment of such taxes currently employed by our major export competitor countries -- Japan, the United Kingdom and countries in Continental Europe.

Section 602 of H.R. 3838 would disrupt this competitive balance by imposing an artificial limit on the amount of withholding taxes that could be claimed as a foreign tax credit by a U.S. bank. Specifically, under section 602, no foreign tax credit is allowed for any foreign gross withholding tax imposed on interest income received or accrued by a U.S. bank, to the extent that the withholding tax exceeds the U.S. tax on the net interest income. Withholding taxes disallowed under section 602 will be treated as non-creditable taxes that cannot be carried back or forward or deducted from foreign income. Such disallowed taxes thus become an expense of lending to a withholding tax country borrower which either must be absorbed entirely by the U.S. bank or passed on to the borrower in higher pricing.

ADVERSE IMPACTS OF CHANGES IN THE FOREIGN TAX CREDIT ON EXPORT FINANCING

If U.S. banks are denied a foreign tax credit for the withholding taxes they pay abroad, they will not be able to extend competitive financing in support of U.S. exporters, because the competition will not allow them to pass this additional cost on to foreign buyers. In this connection, the following examples from some of our members are instructive:

o A regional bank in the Southeast finances exports by a tobacco dealer, who purchases tobacco from U.S. farmers. The tobacco is to be sold to an Australian buyer, who can also obtain similar grade tobacco from Brazil or Korea. Australia imposes a 10 percent withholding tax. Because the Australian buyer is an excellent credit risk, he can demand top market terms from his competing suppliers and their banks. In this case, to be competitive, the U.S. bank quotes the Australian company a rate which is 50 basis points over its cost of funds. This results in a competitive market rate. This competitive rate does not include the cost to the bank of the Australian withholding tax which also must be paid by the U.S. bank. If the U.S. bank could not obtain a tax credit for the withholding taxes paid in this transaction, it would have to pass the costs on to the borrower, else the loan would be made at a loss. However, competition from foreign suppliers will not allow this cost to be passed on, since foreign banks financing such suppliers can absorb the cost of the withholding tax under their tax systems. The result is U.S. financing is not available.

- A regional bank in the mid-Atlantic states discounts foreign trade receivables for a major U.S. coal exporter. Many countries to which the coal is being exported impose a withholding tax on the interest paid on such receivables. These taxes are absorbed by the U.S. bank because of intense foreign competition in commodity export sales. Again, if the U.S. bank were denied a tax credit for the withholding taxes paid, the U.S. bank could not absorb the tax and its pricing would be non-competitive and the export sale would be lost to foreign coal exporters and their banks which could absorb the cost of the withholding tax under their tax systems.

Countless other examples could be given and, in each, the result would be the same. Unilateral changes by the U.S. in its foreign tax credit rules will prevent U.S. banks from extending competitive financing to their U.S. customers and export sales will be lost. In this regard, as the examples above illustrate, trade financing is done to a great extent by regional and smaller banks which are close to their local corporate customers. Regional banks play an especially critical role in financing the exports of smaller business concerns, new to the export market. Thus, reduced tax credits in international lending not only would cause our existing exporters to lose sales but also would prevent newer and smaller companies with export potential from ever reaching the export market.

The effects of a reduced foreign tax credit for foreign withholding taxes is likely to be particularly severe on capital goods exports, which account for almost 50 percent of U.S. exports (1984). Multinational companies with production capabilities worldwide will generally adjust the sourcing of these facilities based on many variable costs, one of which is financing. For example, a U.S. auto manufacturer with an assembly operation in Mexico has been purchasing components from Japan and the United Kingdom. Financial institutions in both Japan and the United Kingdom are able to absorb the withholding tax on interest charged by the Mexican government under their tax systems, thus lessening the financial costs of these purchases. When a U.S. bank was able to make the same type of financing available, the Mexican company began sourcing some of the components from the United States. Provisions such as section 602 of H.R. 3838 would prevent U.S. banks from extending such competitive financing and would thus force more sourcing to occur outside the United States. Provisions such as section 602 of H.R. 3838 would result in more U.S. jobs --

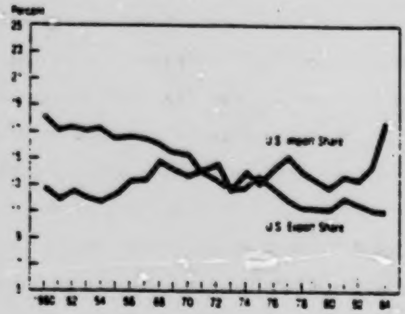
not more U.S. goods and commodities -- being exported from the United States.

ADVERSE IMPACTS ON U.S. EXPORTS

Trade balances are one indicator of a nation's competitiveness in world markets. Large trade deficits indicate a nation's inability to sell abroad as much as it purchases from abroad. As Chart I illustrates, U.S. competitiveness has steadily declined since 1960 as measured by its share of the world market of exports and imports.

CHART I

U.S. SHARE OF WORLD
EXPORTS AND IMPORTS
1960-84



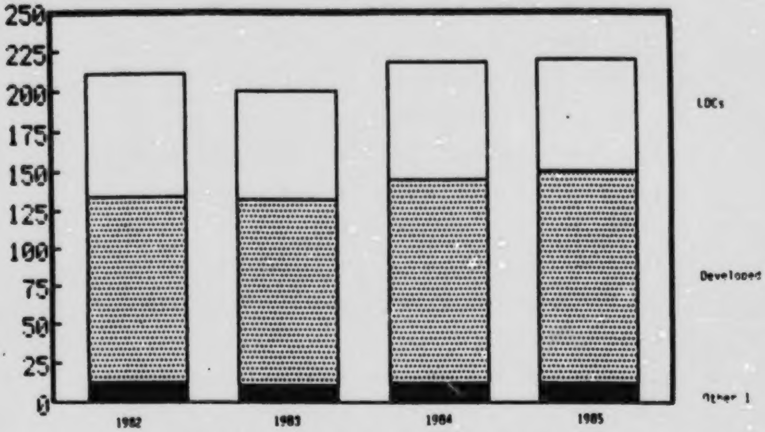
Source: United States Trade
Performance in 1984

U.S. Department of Commerce, 1985

Of the countries imposing withholding taxes, 23 are industrial countries, 26 are less-developed countries ("LDCs") and one (1) is a centrally-planned economy. For 1984, U.S. exports to all industrial countries accounted for 61 percent of total U.S. exports, while exports to all LDCs accounted for 33 percent of total U.S. exports (see Chart II).

CHART II

TOTAL U.S. EXPORTS BY COUNTRY CATEGORY



1/ Other includes special category or military type goods exported and included in total U.S. export figure, but not allocated to respective recipient country. Also includes exports to centrally planned economies.

Estimated 1985 annualized figure based on January through June

Source: U.S. Department of Commerce, U.S. Foreign Trade Highlights, 1985

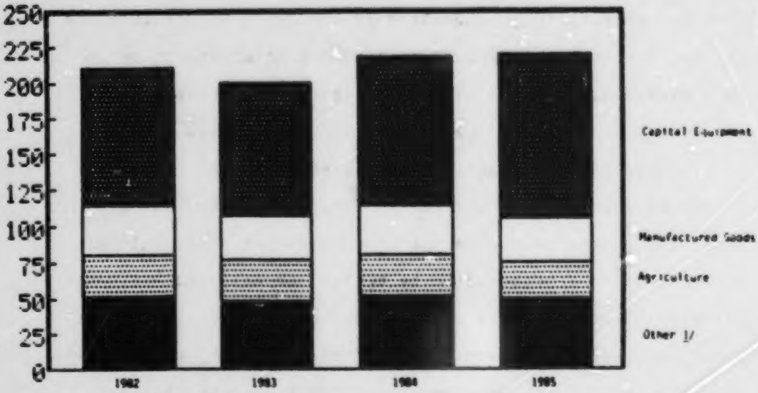
The importance of U.S. trade is not only in terms of the balance of trade statistics but also as to how exports translate into U.S. employment. Statistics recently published by the Department of Commerce indicate the importance of remaining competitive in foreign markets for the employment considerations that result from the export of U.S. goods and services.

- MERCHANDISE EXPORTS accounted for nearly 25,000 U.S. jobs per $1 billion of U.S. merchandise exports. One out of every eight jobs in manufacturing is attributed to exports, or in aggregate terms, merchandise exports accounted for almost 4.5 million jobs in the U.S. in 1984.
- AGRICULTURAL EXPORTS accounted for one out of every four acres of U.S. farmland in production, and represented 14.7 percent of U.S. exports in 1984. The Department of Commerce estimated that agricultural exports generated employment for over 700,000 persons in 1980.
- SERVICES exported generated over 2 million jobs in 1984.

U.S. exports by economic sector to all countries are shown in Chart III. Capital goods (i.e., machinery and equipment) accounted for the largest proportion (47 percent), while manufactured goods (15 percent) and agricultural products (14 percent) accounted for the next largest shares of exports in 1984.

CHART III

TOTAL U.S. EXPORTS BY TYPE
1982-1985*
($ BILLIONS)



1/ Other includes: Exports of chemicals, fuels and lubricants, and raw materials

* Estimated 1985 annualized figure based on January through June

Source: U.S. Department of Commerce, U.S. Foreign Trade Highlights, 1985

ARGUMENTS FOR LIMITING THE FOREIGN TAX CREDIT ON WITHHOLDING TAXES HAVE BEEN BASED ON THEORETICAL AND MARKET MISCONCEPTIONS

The House Report accompanying H.R. 3838 sets forth a number of purported reasons for denying or limiting foreign tax credits for gross withholding taxes on the foreign loans of U.S. banks. These purported reasons are all based on theoretical or practical misconceptions.

First, it is suggested in the House Report that the foreign tax credit somehow creates a financial incentive to lend overseas. That is simply incorrect. As shown by the examples previously discussed, foreign tax credits merely permit U.S. banks to extend competitive financing to foreign buyers of exports from the banks' U.S. customers. The U.S. bank still makes only a very narrow margin in international lending, which is determined by market competition. It would be more correct to state that without the foreign tax credit, U.S. banks could not lend competitively overseas, since competition would force U.S. banks to lend at non-competitive pricing terms.

Second, it is suggested in the House Report that foreign borrowers from U.S. banks almost always assume the economic burden of the withholding tax. Again, this is factually inaccurate. The U.S. bank, not the foreign borrower, bears the liability for the withholding tax. U.S. banks often assume the full cost of the withholding tax, i.e. do not pass it on to the borrower in pricing, in order to be competitive with foreign banks, as illustrated by the examples previously given.

Third, it is suggested in the House Report that "net loans," i.e. loans made at a stated interest rate net of foreign withholding taxes, somehow confer an unfair tax credit, since the borrower agrees to pay the withholding tax on behalf of the bank. This too is wrong. Net loans do not cost U.S. tax revenues. Loans are sometimes structured as net loans for convenience in administration and for pricing and marketing considerations. The withholding taxes paid by the borrower are included in the interest which must be reported by the bank for tax and financial reporting purposes. The tax treatment and the spread to the bank are thus the same whether the borrower pays the withholding tax or the bank pays it and indicates it in a higher interest rate. Competitive and other pressures also make the foreign tax credit critical for such "net" loans. If the U.S. bank cannot obtain a tax credit for the withholding taxes paid and reflected in its interest rate, it would have to further increase the cost of its financing, which either would make its loans uncompetitive or, especially in the case of the LDCs, would make its loans too expensive. In either case, U.S. export sales would be lost.

Lastly, it is assumed in the House Report that reduction of the foreign tax credit on foreign withholding taxes will increase tax revenues by a modest amount. This assumption, we believe, is incorrect. If U.S. banks cannot competitively finance exports from the U.S., it means less U.S. exports, less U.S. production, less U.S. jobs, and less overall tax revenue. In particular, if financing becomes cheaper from foreign banks at foreign locations, multinationals will be encouraged to export more from jurisdictions outside the U.S., thus causing further declines in U.S. production, jobs and tax revenues.

CONCLUSION

Retention of the present foreign tax credit rules is critical to the competitive financing of U.S. exports. Competitive trade financing is critical to the growth of U.S. exports. Exports are critical to increased U.S. production and jobs. Retention of the present foreign tax credit rules is thus critical to our national economic and trade interests.

EXHIBIT A

FOREIGN COUNTRIES IMPOSING WITHHOLDING TAXES

Developed Countries

Australia
Austria
Belgium
Canada
Denmark
Finland
France
Greece
Ireland
Italy
Japan
Luxembourg
Netherlands
New Zealand
Norway
Portugal
South Africa
Spain
Sweden
Switzerland
Turkey
United Kingdom
West Germany

Less Developed Countries

Argentina
Bolivia
Brazil
Chile
Columbia
Ecuador
Egypt
Hong Kong
India
Indonesia
Iran
Malaysia
Mexico
Morocco
Nigeria
Pakistan
Philippines
Saudi Arabia
Singapore
South Korea
Taiwan
Thailand
Tunisia
Uruguay
Venezuela

Centrally Planned Economy

China

WRITTEN STATEMENT OF THE BANKERS COMMITTEE TO
THE SENATE FINANCE COMMITTEE

BOB PACKWOOD, CHAIRMAN

HEARINGS ON THE TAX REFORM ACT OF 1985

FEBRUARY, 1986

The Tax Reform Act of 1985 - Economic Impact and Effect on Financial Institutions

INTRODUCTION

Many months of intense negotiation between House tax Members, the Administration and numerous interested groups culminated in the legislation sent to the Senate. The Tax Reform Act of 1985 (H.R. 3838). Mr. Chairman. you have wisely requested that financial institutions and others concerned over the impact of the bill outline their support of or problems with the bill.

Tremendous changes are taking place in the financial industry due to technological changes and deregulation. These as well as other factors influencing competition, operating expense, and macroeconomic considerations are of great interest to all involved. Fiscal policy and Federal income taxes play significant roles in commercial banks' ability to compete and operate profitably.

The Bankers Committee, a membership organization of approximately 1000 banks appreciates this opportunity to present our views on certain aspects of the Tax Reform Act. Even though the Senate Finance Committee may not work from the House passed bill, the issues we discuss will undoubtably find their way into the Committee's deliberations. We hope our comments are helpful to the Committee Members and other Members of the Senate.

The early attention given the tax overhaul measure indicates that the bill does indeed comprise major tax revision, although some would hesitate to call it "tax reform". To some, a reduction in individual tax rates of 9 percent financed by $140 billion in corporate and business tax increase represents reversal of the President's 1981 tax act designed to stimulate investment and economic growth. Others view the measure as a positive development in a series of tax reform efforts with the Tax Equity and Fiscal Responsibility Act and the Tax Reform Act of 1984 as building blocks.

What must be remembered are the goals of tax reform, a more nuetral sytem, low marginal rates to encourage work and thrift, and a halt to tax avoidance. This would promote a sound, growing economy.

At this time, we are not prepared to endorse this legislation as a means to achieve these goals. in fact, in a statement to House Ways and Means Chairman Dan Rostenkowski earlier this year, we urged consideration of a plan much different than what we are discussing today.

The Bankers Committee urged the Committee to examine a sweeping proposal that would go a long way to simplify the tax code, eliminate high marginal rates and the resulting loss of economic resources devoted to tax avoidance. and shrink substantially the underground economy which cost the Treasury billions.

The plan for business is a flat tax of 19% with deductions only for usual business expense. According to authors of the plan Stanford economist Dr. Robert Hall and his collegue Alvin

Rabushka, the plan would have brought into the tax base economic income sufficient to raise corporate Federal income tax revenues by 20 percent in 1980. Considering that the effective tax rate of corporations in 1981 was about 23%, the simple flat tax presents an interesting alternative.

Right now, I would like to respond to your questions Mr. Chairman about the impact of H.R. 3838 on our predominately small bank members.

Even with the corporate rate reduction from 46% to 36%, most of our members would experience tax increases. More importantly, the bill fails to address an issue of tax policy that has been a chief concern to this group for many years. That issue being equal treatment of similar income. This concern is dealt with in detail in Section I of our statement on bad debt reserves and Section III on credit union tax treatment. Before we address those issues, let me briefly discuss the environment surrounding bank tax treatment and policymakers who formulated the financial institutions section of H.R. 3838.

For many years, Congress has heard much about the effective tax rates for commercial banks. Both the Joint Tax Committee and the U.S. Treasury have stated or published information that details low or negative tax rates for the twenty largest banks in the country. As most of the Members of this committee are aware, these tax rates do not reflect the total contribution banks make to Federal Revenue. Last year alone, the Treasury Department raised $ 2 billion from banks through interest income from Federal Reserve mandated deposit reserve accounts. This signifi-

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cantly raises the effective tax contribution of banking to Federal government finances and we appreciate your consideration of this issue.

Now I will discuss provisions of specific interest to the members of the Bankers Committee.

Section I BAD DEBT RESERVES

Since 1921, banks have been permitted to use a reserve method in calculating the federal income tax deduction for bad debts. The reserve account is, in effect, an offset to a bank's outstanding loan assets, reflecting the fact that a portion of outstanding loans will prove to be uncollectible. Under the reserve method, the bad debt deduction for a taxable year is equal to the amount required at year-end to restore the reserve to an appropriate level computed under certain approved methods.

The House tax bill (H.R. 3838) would reverse this 65-year history and experience in the case of "large banks" (i.e., generally, banks having assets with tax bases exceeding $500 million) requiring use of a specific charge-off method. A deduction is allowed for bad debts only when a particular debt owed the bank becomes either wholly or partially worthless. Moreover, "large banks" would generally be subject to recapture of the existing bad debt reserve under a provision that requires the entire reserve amount to be added back to a bank's taxable income over a 5-year period.

The specific charge-off method in H.R. 3838 represents bad tax policy, and it should be rejected by the Senate. Instead, the Senate should adopt the Roth-Flippo proposal that retains the reserve method of accounting for bad debts and requires generally that the bad debt reserve for tax purposes be conformed to the bad debt reserve maintained for financial statement purposes.

Problems With Specific Charge-Off Method Required Under H.R. 3838

A mismatching of income and expense is inherent in the specific charge-off method. The proper measurement of a bank's net income must take into account the fact that interest received on outstanding loans is partially offset by the subsequent failure to collect interest and principal on loans in the portfolio that ultimately prove to be bad. If a loan loss is not deducted until a specific loan becomes completely worthless or partially worthless, a bank is required to report interest income on good loans (and perhaps on bad loans) prior to the time it reports the related loan portfolio loss. The result is an overstatement of a bank's current taxable income.

. This mismatching of income and expense under the charge-off method has resulted in its rejection by accountants and financial regulators as a proper means of financial reporting for banks. Banks are required for financial reporting purposes to maintain a reserve for bad debts to reflect accurately the value of the loan portfolio and the amount of net income for any accounting period. In the absence of a reserve account a bank's soundness may be imperiled by an artificial inflation of assets and income.

The proponents of the specific charge-off method concede that the method results in a current mismatching of income and expense, but they argue that the mismatching is subsequently corrected. They argue that a "risk premium" increment is collected on good loans to compensate for losses on bad loans and that the present value of the incremental income is equal to the present value of the loss. Under this theory, the present value of the current additional tax liability on the incremental income is said to be equal to the present value of the tax savings that will result later from a claiming of the loss. The theory flies in the face of principles that have long been required for bad debt reporting by the accounting profession, the SEC, and bank regulators. But, even if the theory was correct in an academic sense, it does not reflect real world situations. The inherent mismatching under the specific charge-off method is increased considerably when it is applied in practice.

The theoretical argument for the specific charge-off method is apparently based on the assumption that a charge-off is made, and a loan loss deduction is therefore available, at the precise moment a loan becomes non-performing (i.e., at the moment there is any default on payments of interest or principal). In fact, charge-offs typically occur after a protracted period of non-performance and may be delayed until all efforts to structure a work-out arrangement with the debtor completely fail. The result is a deferral of a loan loss deduction under the specific charge-off method substantially beyond the time assumed by the theoretical proponents.

There can be little doubt that the specific charge-off in actual operation would overstate current income and would fail to provide adequate understatement of income in later years to compensate.

In addition to the fundamental flaw of income overstatement, other problems would be created by the bad debt provisions of H.R. 3838. For instance, the specific charge-off method is especially difficult to administer.

In practice, the charge-off of specific loans is not a process conducted with mathematical precision. It calls for an exercise in judgment by bank officials and can provide considerable latitude for determining the particular moment when a loan is completely or partially "worthless." This inherent uncertainty, and resulting abuse potential in the specific charge-off method led to the Congressional decision 65 years ago to provide for the use of reserves to account properly for loan losses.

Moreover, the required use of the specific charge-off method may have an adverse impact on bank lending practices. Since the charge-off method necessarily links the loan loss tax deduction with the timing of the bank's write-off determination banks will have a tax incentive to write off loans earlier than general bank procedures might otherwise dictate.

This incentive for earlier write-offs can be expected to work to the disadvantage of debtors experiencing temporary financial difficulties. The impact of this development could be especially harmful to certain small business sectors and of course, the agricultural sector of the economy.

During Congressional discussions of the minimum tax on preferences in 1983 and 1984, the Bankers Committee recommended removing bad debt reserves from the list of preferences subject to the minimum tax and an increase in the bad debt reserves rate for banks with large agricultural portfolios in order to avoid this very problem.

In 1986, these problems are even more pressing. Eliminating reserve accounting in this environment would be especially short-sighted. The problems that would arise for banks and their customers would far outweigh any conceivable benefit to the Treasury from the specific charge-off proposal. Relatively little revenue is gained from the reduced bad debt deduction under the proposal.

Most of the gain would be realized from the provision for a recapture of existing reserves. The bill would force banks to include in their income all exsisting reserves over a five year period or alternatively through a so-called cut-off method having about the same effect.

Regardless of what decisions are made with respect to the basic bad debt issue, the recapture provision seems especially onerous. On many other occasions when Congress has required accounting changes, there has been no recapture from the taxpayer. For example, there was generally no recapture with respect to accounting changes required by enactment of the 1954

Internal Revenue Code, nor was recapture required with respect to the substitution of the FSC provisions for the DISC provisions in the Tax Reform Act of 1984. The Congress should be suspicious of a proposal whose chief virtue appears to be its ability to extract revenue through an onerous transition rule.

Finally, we would like to dispel any notion that the bad debt changes would affect only large banks. The authors of H.R. 3838 believe that they have arrived at a formula which would increase effective taxes on "large banks" by subjecting banks and banks that are members of holding company groups with total assets of $500 million or more to bad debt resrictions and the recapture tax. Unfortunately for many smaller banks, especially those in economic sectors experiencing increasing rates of non-performing assets, this arbritary cut-off incorporates their institutions. Under H.R. 3838 groups of smaller banks that have formed a holding company are subject to the change. The following examples of instititions that fall into this category illustrate the problem.

A SAMPLE OF BANK HOLDING COMPANYS SUBJECT TO RESERVE ACCOUNTING METHOD CHANGE

Remember, these institutions will also be subject to the recaputure provisions which require the banks to add back to income the current amount of bad debt reserves or account for

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loans outstanding on the cutoff method.

BANK NAME	CITY	ST	ASSETS
MAGNA GROUP INC.	BELLEVILLE	IL	
First N.B. of Belleville	Belleville	IL	$348,832
Bank of Belleville	Belleville	IL	180 290
First N.B. in Columbia	Columbia	IL	52,232
Fairview Heights Cmnty Bank	Fairview Hgts	IL	31.016
First N.B. of Marissa	Marissa	IL	30,720
Dupo State Savings Bank	Dupo	IL	25,787
First N.B. of Smithton	Smithton	IL	11,595
Illinois State Trust Company	Belleville	IL	0
First N.B. of Freeburg	Freeburg	IL	27.012
MAGNA GROUP TOTALS			$707,484 ASSETS
BRENTON BANKS, INC.	DES MOINES	IA	
Brenton N.B. of Des Moines	Des Moines	IA	203,802
Fidelity Brenton Bank & Trust	Marshalltown	IA	92,440
Brenton First National Bank	Davenport	IA	82,729
Poweshiek County N.B.	Grinnell	IA	77 819
Brenton Bank & Trust Company	Adel	IA	64,275
Brenton National Bank of Perry	Perry	IA	63,888
Community N.B. & T.C. of Knxvlle	Knoxville	IA	58,824

Brenton State Bank of Jefferson	Jefferson	IA	55,982
Brenton State Bank	Dallas Ctr.	IA	51,020
Palo Alto County State Bank	Emmetsburg	IA	50 759
Brenton Bank & Trust Co.	Urbandale	IA	39,462
Brenton Bank & T.C. of Vinton	Vinton	IA	34,014
Warren City Brenton B & TC	Indianola	IA	33,183
Brenton Bank & Trust Co.	Clarion	IA	32 258
Brenton B & T.C. of Cedar Rapds	Cedar Rapids	IA	30,847
Brenton State Bank	Eagle Grove	IA	21.850
BRENTON GROUP TOTALS			$993.157 ASSETS

HAWKEYE BANCORPORATION	DES MOINES	IA	
Jasper County Savings Bank	Newton	IA	109.801
Hawkeye-Capital B & T.C.	Des Moines	IA	105,824
Hawkeye Bank & Trust Company	Burlington	IA	102,170
First National Bank	Clinton	IA	78,855
Citizens N.B Boone	Boone	IA	78,172
Hawkeye Bank & Trust Co.	Humboldt	IA	76.155
Pella National Bank	Pella	IA	74.388
Hawkeye Bank & Trust Co.	Maquoketa	IA	74,083
Houghton State Bank	Red Oak	IA	69.255
Hawkeye Bank & Trust Co. N.A.	Centerville	IA	65,980
Hawkeye B & T.C. of Des Moines	Des Moines	IA	63,983
Commercial State Bank	Marshalltown	IA	61,410

Hawkeye Bank & Trust Co.	Mt Ayr	IA	51.234
State Bank of Vinton	Vinton	IA	47,138
United State Bank	Cedar Rapids	IA	46.963
Tipton State Bank	Tipton	IA	44,643
Onawa State Bank	Onawa	IA	44.004
Waukon State Bank	Waukon	IA	42,581
Hawkeye Bank & Trust Co.	Spencer	IA	41,101
National Bank of Washington	Washington	IA	40,800
Lyon County State Bank	Rock Rapids	IA	37.915
Hawkeye Bank & Trust Co.	Chariton	IA	37,675
First National Bank in Lenox	Lenox	IA	33.813
Hawkeye Bank & Trust Co.	Grundy Center	IA	31,485
Hawkeye Bank & Trust Co.	Mt. Pleasant	IA	28.415
Hawkeye State Bank	Iowa City	IA	26,099
Hawkeye B & T.C. Mason City	Mason City	IA	25.758
Hawkeye-Ankeny Bank & Trust	Ankeny	IA	25,436
Lake City State Bank	Lake City	IA	25.178
Hawkeye Bank & Trust	Lake Mills	IA	24,789
State Bank of Allison	Allison	IA	22.489
First National Bank of Sibley	Sibley	IA	20,820
Hawkeye Bank & Trust Co.	Eldora	IA	20.501
Hawkeye Bank & Trust Co.	Camanche	IA	15,283
HAWKEYE GROUP TOTALS		$1,807,425 ASSETS	

This is just a limited sample of the small banks that are caught up in the definition when holding company members are included for purposes of the $500 million cut-off. The provisions would have significant impact on many community banks across the county.

The Reserve Method of Accounting Should Be Retained for Banks and Improved by Adoption of the Roth-Flippo Proposal.

The Roth-Flippo proposal would retain a reserve system for deducting bad debts as long as the amount of the reserve generally conformed to the bad debt reserve maintained for financial statement purposes. However, the maximum bad debt reserve could not exceed 1.5% of the total loans, and the maximum bad debt deduction in any taxable year could not exceed 0.5% of total loans outstanding at the end of that year.

This approach reflects the fact that a bad debt reserve is needed to match properly the income of the loan portfolio with related expenses resulting from bad debt losses. It also reflects the fact that the most reliable indicator of the proper amount of reserve is the amount that is reported as a reserve for financial purposes.

There is a natural tension between financial reporting and tax reporting that should act to keep bad debt reserves within reasonable bounds. Any determination of bad debt losses, whether through a reserve method or a specific charge-off method will be imprecise and will present some abuse potential. However, any tax benefit associated with overestimation of reserves will generally be more than offset by the disadvantage of underreporting financial income.

Therefore, the Roth-Flippo conformity approach provides a self-regulating mechanism for accurate matching of income and expense.

Thrift Institutions' Percentage of Taxable Income Method

The treatment of thrift institutions in H.R. 3838 as regards provisions on bad debt reserves brings into question the entire basis for the treatment of commercial bank's bad debt reserves. Somehow, the committee devised justification for continuing very favorable treatment for savings and loans as compared to commercial banks and taxpayers generally.

The bill provides that thrifts will be allowed both the experience method and percentage of income method for bad debt reserve deductions. Any institution meeting a "thriftness test" will be allowed a deduction up to 5 percent of income. Additionally, institutions which claim the 5 percent of taxable income method will not be considered as having obtained a tax preference for purposes of the 20-percent reduction.

This preferential treatment bestows a competitive advantage over commercial banks and should be eliminated.

Section II TAX-EXEMPT CARRYING CHARGES DISALLOWANCE

H.R. 3838 disallows 100 percent (as opposed to 20 percent under current law) of the deductions for interest expense attributable to exempt obligations obtained after December 31, 1985.

Commercial banks purchase tax-exempts for a number of reasons including asset diversification and the opportunity to fulfill obligations to their local community.

Across the country, there are a number of communities that have no bond rating or an inferior rating. Local banks provide the only markets for such offerings. Due to recent legislation, this market is declining. Tax law modification in the 1982 Tax Equity and Fiscal Responsibility Act and the 1984 Tax Reform Act which reduces the carrying charge deduction by 20%, has had substantial impact on the willingness and ability of banks to invest in such bonds. According to Federal Reserve System 1984 flow of funds reports, $547 billion in tax-exempts bonds were distributed in the following ratios among different investors: Households were the largest investors with 38.8%, commercial banks were second with 32%, property and casualty insurance firms held 15.5%, mutual funds held 8.2% and life insurance firms possessed 1.8%. Other investors account for the remaining 4%.

The relevance of these figures does not become apparent without a comparison to years prior to 1983 when banks traditionally had been the largest holder of tax-exempt bonds with 50 to 60% of the total market.

In discussions with numerous bank Presidents about the impact of the 1982 and 1984 tax law changes and the prospect for a 100% disallowance, many stated that they could no longer invest in the state and local bonds because of the inherently higher risk, lack of liquidity and low return.

To maintain a bank market, state governments would have to at least match the interest rate of U.S. Treasury instruments, and local communities would have to surpass that rate by 50 to 75 basis points or more. Otherwise bank management would violate its fiduciary duty to stockholders if it acquired such bonds. A study conducted on the impact of an Internal Revenue Service ruling designed to terminate deductions for certain public deposits secured by tax-exempt securities concluded the ruling would have increased cost to local governments by up to $2.15 billion.

Importantly, it should be noted that strong opposition was voiced at Senate Finance Committee hearings on Tax Reform and Tax-Exempt Bonds hearings September 24, 1985. John T. Walsh, Finance Director of the Government Finance Officers Association stated:

> "The Government Finance Officers Association opposes the Administration's proposal on tax-exempt bonds because it affects general obligation bonds and revenue bonds issued for governmental purposes. The elimination of the deduction taken by banks and other financial institutions for the cost of buying and carrying bonds will hurt many small jurisdictions that rely on local institutions for their capital financing."

The State Treasurer of South Carolina, Grady Patterson, Jr., said this about the proposed change,

> "Prior to 1982, a 100% deduction was allowed for such cost incurred to buy or carry tax-exempts, and the elimination of such deduction will drive away and eliminate a large segment of our market for municipal bonds. I urge the removal of the proposal to deny deduction for cost incurred in buying and carrying tax-exempt obligations."

These are just a couple of the comments at the Finance Committee hearing that demonstrate the adverse affect on local communities of H.R. 3838's provision on bank interest costs.

Banks often purchase tax-exempt bonds to meet required pledging obligations for public deposits in excess of deposit insurance limits. Approximately 35 states and numerous local governments require banks to secure public deposits with bonds issued by the state or local government. These relationships will be disrupted by H.R. 3838 to the disadvantage of the states and local communities.

It must be clearly understood that the tax advantage derived from bank investment in municipal bonds is passed through to the communities. This role of financial intermediary was devised by the Congress to reduce the local economic burden when educational, infrastructure and other projects require financing. A change in the tax code which eliminates the ability of banks to participate in such bonds, unless rates are increased systematically, will not alter bank's profits, but will affect total investment in such instruments unless new markets can be found.

The deduction for state and local bonds does not constitute a "tax loophole or preference" but instead comprises a long accepted Federal policy of encouraging local communities to institute self-development measures. The practical effect of the present carrying cost deduction is to reduce the overall cost of financing for worthwhile projects. Not only do the proposed changes in current law treatment of tax-exempts impact the issuance of such bonds, but also the market for bonds now held by banks.

Troubled banks may need to sell municipal obligations they now hold in order to replace them with higher earning assets. This liquidity will be severely restricted by tax changes under H.R. 3838. In order to maintain a market for obligations previously purchased and maintain a reasonable incentive for bank investment in State and local bonds by banks, Bankers Committee recommends the following modifcations of the prosposed act:

1) An exemption from the 100 percent disallowance for any bonds acquired from a bank that were held by that bank since enactment of the tax bill.

2) Elimination of the requirement in the transitional rule that limits the continued 100% deduction to bonds issued in the same state as where the bank is located. Many communities are located in more than one state and their natural market is multi-state. Also, some states have virtually no local bond market.

3) Raising the $10 million annual aggregate limitation to at least $25 million. The arbitrary $10 million is far too low considering the infrastructure and and the need of states and communities.

4) Change of the transitional rule to a permanent exemption.

Clearly, any geographical or excessively low dollar amount limitation constitute legislative "overkill" and an undue burden on state and local communities.

Section III CREDIT UNION COMPETITION AND TAXATION

For a number of years, the Bankers Committee has advocated the taxation of credit unions. Although the credit union industry has experienced extensive growth in the past few years, head-to-head competition with tax exempt credit unions has concerned community bankers since the early sixties.

More recently, independent bankers that are attempting to deal with increased operating expense brought about by financial deregulation, find their credit union competition more sophisticated and quite effective at luring away customers.

Consider the following statistics outlining growth of the CU industry.

Credit union representatives assert that their growth is not disproportionate from other classes of financial institutions. exclaiming that 98 percent of Federal credit unions had assets of less than $100 million. How can these small financial institutions compete with commercial banks like Citibank and Bank of America? Well, that question has never been the issue. The issue of competitive equity centers on a $25 or $50 million credit union competing with a $25 or $50 million commercial bank. Two small financial businesses, competing for the same group of customers in the same geographical area. Only one has considerably less regulatory burden and tax obligation.

This is where the figures on credit union growth shed some light on competitive equity.

Today, credit unions are the fastest growing financial institutions in the nation. There are almost 20,000 credit unions compared to 14,000 banks. Membership growth has been vigorous since the 1960s, more than doubling from about 21 million to 49 million by the end of 1983. Credit unions surpassed the 50 million member mark in 1984 and by mid-1985 reached an all time high of 51.6 million members. That equals almost one-fifth of the U.S. population.

Savings at federal credit unions surpassed $54 billion in 1983. A growth rate of 20.7 percent for the year which was more than twice the deposit growth rate for commercial banks. For a twelve month period ending in August 1985. savings continued to grow at an annual rate of 20.8 percent for all credit unions. For Federal credit unions. savings surged by $8.3 billion to $66.2 billion, which compares very favorably to $3 billion of growth for the same period a year earlier.

Figures for loan growth are equally impressive. During 1983. loans at Federal credit unions grew 18 percent. For all credit unions, total loans outstanding soared 28 percent. For a twelve month period ending in mid-1985 loans outstanding increased by 15.1 percent. A period of low loan demand for most financial institutions.

Finally, some brief figures on overall growth of the credit union industry. Total assets demonstrate year in and year out growth experienced by the credit union industry. In 1975. total assets equaled $37.9 billion. by 1980 the industry expanded to

$72.4 billion. The magical $100 billion mark (the point at which savings and loans where subject to Federal taxation) was achieved in 1983. Total asset growth for twelve months ending in August hit a rate of 20.8 percent, pushing the industry to $133 billion in assets.

Historically, infant industries have been granted tax subsidies to promote provision of the anticipated benefits to the American public. Just as judiciously, Congress has been called upon to remove tax favoritism when self-sufficiency is achieved. When one examines the viability and robust condition of the credit union industry, it is obvious that complete tax exemption is no longer necessary.

. Importantly, when one looks beyond the growth figures to determine who the patrons of credit unions are, a different profile emerges than what one would expect from a "self-help" oranization providing financial opportunities for low-income Americans.

This examination brings our analysis to the heart of the argument for or against continued tax exemption. Have credit unions drifted away from their non-profit and/or mutual orientation?

The Credit Union National Association has from time to time published a national member survey. This extensive report contains nearly 100 tables and provides considerable information on typical credit union members and their use of financial services. It covers members and, for comparative purposes, nonmembers as well. While the study is slightly slanted toward members of smaller credit unions, it is the best information available. To get an idea of the membership of large credit unions, simply consider some of the top few credit unions by name. The characteristics of their membership are obvious. Credit unions, such as the Navy Federal Credit Union with 700,000 members and over $1.6 billion in assets, the Pentagon Federal Credit Union and the United Air Lines Credit Union do not have a majority or even a large percentage of low-income members.

Overall, the study found that CU members are somewhat younger, more affluent and more concentrated in professional and managerial occupations than non-members. They are more likely to own their own homes, and a far greater portion have income above $25,000.

It is interesting that credit unions were viewed most favorably on price comparisons rather than services. Best loan rates and best interest on savings were primary motivating factors for membership while many respondents stated that commercial banks remained their primary financial institutions. Contrary to the views expressed by representatives of the credit union industry, the report demonstrates that most members have accounts at various financial institutions and do not rely only on the credit union for services. Only about one-third stated that they had their main account with the credit union.

The customer profiles raise the spector that credit unions are simply transferring federal benefits to individuals with the good fortune to work at a company that sponsors a credit union or with the equally good luck to live in a community that has somehow acquired a credit union. We doubt that Congress originally intended to provide tax exemption to these types of institutions.

While growth and expansion is the goal of any business organization, the desire to aggressively compete with other sectors of the financial industry has moved credit unions away from their original purpose. The more affluent and better educated customer base of credit unions outlined by Credit Union National Association's survey is due not only to pricing advantages bestowed by Federal and State tax benefits but also by an array of new products and marketing techniques.

Consider the following examples of products, who might use the products and whether the Federal government should subsidize the activities.

*Litton Employees Federal Credit Union offers members a discount brokerage product with margin accounts, capacity to trade options, securities, etc. A similar product is offered by IBM's credit union service corporation, American Brokerage.

*A policy adopted by the National Credit Union Administration in November of 1984 encourages credit unions to form "senior clubs" and enroll senior members without regard to common-bond or

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income.

*A credit union owned service corporation was recently initiated to process VISA and Mastercard payments and otherwise manage credit card services for members.

Of course federal legislation has made various financial products available to CUs including second mortage loans, share draft accounts (which function like checking accounts) and $100,000 share insurance on individual accounts, just to name a few.

Again, while growth is the goal of all business organizations, growth also leads inevitably to changes in businesses. It is evident that this has occurred in the credit union industry. The array of products similar to other financial institutions and the deterioration of common-bond have vastly changed the characteristics of credit union membership.

Apply Cooperative Tax Law to Credit Unions

While many members of the Bankers Committee would prefer to see complete taxation of income without regard to the concept of mutual ownership and the corresponding limitations on economic income, we are today endorsing the tax reform proposal outlined by the Administration in the "The President's Proposals to the Congress for Fairness, Growth and Simplicity" presented to the Congress in May of 1985.

Essentially, the proposal is an attempt to conform credit union taxation to current law regarding mutual type organizations. Surprisingly, few have noted that credit union tax exemption is highly unusual treatment for a service, membership organization. While cooperative organizations are generally considered by the Treasury Department to merit "pass-through" treatment, much like a partnership, they are not accorded complete tax exemption.

The adminstration's proposal is not simply a measure to advance competitive equity, but indeed is an attempt to correct an abuse of a basic tax policy tenant of taxing similar income in a similar manner.

. Credit unions, if they are true cooperative business organizations should be taxed under Subchapter T of the IRC, which applies generally to all types of co-ops. Importantly, Subchapter T provides special treatment with a deduction for earnings distributed to members not allowed other taxpayers.

This special treatment provides for taxation of distributed earnings only once, allowing the business entity tax exemption on distributed earnings. In the case of credit unions, income tax paid at the Federal level would be reduced by distributing dividends to members.

As with other cooperative businesses, fair tax treatment would dictate that provisions of Subchapter T apply to all credit unions regardless of size to ensure that the benefits of single

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taxation are available to all consumers.

Mr. Chairman, we appreciate this opportunity to present our views to this important Senate Committee and our staff will be happy to provide any assistance necessary as legislation is developed to enact tax reform.

BAPTIST JOINT COMMITTEE ON PUBLIC AFFAIRS
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OLIVER S. (BUZZ) THOMAS
GENERAL COUNSEL

Summary of the Points Made in the Statement of
the Baptist Joint Committee on Public Affairs
and the Church of the Brethren

to the
Committee on Finance
United States Senate

on
H.R. 3838 (The Tax Reform Act of 1985)

January 29 and 30, and February 4, 5, and 6, 1986

1. **If enacted, §1012 of H.R. 3838 (The Tax Reform Act of 1985) will result in the taxation of the church pension and welfare benefits boards.**

2. These boards are carrying out the churches' spiritual task of providing for their needy and retired ministers and are, therefore, **an integral and inextricable part of the mission and ministry of the local churches.**

3. Taxation of the church boards will result in the following:

   a. **conflict and confrontation** with the churches leading inevitably to a morass of litigation

   b. **excessive entanglement** between church and state caused by the continual surveillance, monitoring and investigation required by taxation.

4. §1012 constitutes **a radical departure from the time tested principle that the state is not allowed to support the church and, more importantly in this case, the church is not required to support the state.**

5. §1012 should be deleted from H.R. 3838 or amended to provide an exemption for "church plans" as defined in §414(e) of the Internal Revenue Code.

6. **Taxing the meager resources of the pensions of retired ministers and missionaries would yield a minimal amount of revenue but would wreak a maximum amount of damage on these already undercompensated servants of the church.**

AMERICAN BAPTIST CHURCHES IN THE U.S.A.
NATIONAL BAPTIST CONVENTION OF AMERICA
PROGRESSIVE NATIONAL BAPTIST CONVENTION, INC.
BAPTIST FEDERATION OF CANADA
NATIONAL BAPTIST CONVENTION, U.S.A.
SEVENTH DAY BAPTIST GENERAL CONFERENCE
BAPTIST GENERAL CONFERENCE
NORTH AMERICAN BAPTIST CONFERENCE
SOUTHERN BAPTIST CONVENTION

STATEMENT OF THE
BAPTIST JOINT COMMITTEE ON PUBLIC AFFAIRS
AND THE CHURCH OF THE BRETHREN

on

H.R. 3838 (The Tax Reform Act of 1985)

to the

COMMITTEE ON FINANCE
UNITED STATES SENATE

January 29 and 30, and February 4, 5, and 6, 1986

The Baptist Joint Committee on Public Affairs is composed of representatives from eight national cooperating Baptist conventions and conferences in the United States. They are: American Baptist Churches in the U.S.A.; Baptist General Conference; National Baptist Convention of America; National Baptist Convention, U.S.A., Inc.; North American Baptist Conference; Progressive National Baptist Convention, Inc.; Seventh Day Baptist General Conference; and Southern Baptist Convention. These groups have a current membership of nearly 30 million.

Through a concerted witness in public affairs the Baptist Joint Committee seeks to give corporate and visible expression to the free exercise of religion for all persons, the separation of church and state, and the relevance of Christian concerns to the life of this nation. Because of the congregational autonomy of individual Baptist churches, we do not purport to speak for all Baptists.

The Church of the Brethren is a pacifist church with approximately 170,000 members in the United States. The founders of the church were forced by religious persecution to flee their native Germany and settled in Pennsylvania. Because of this heritage and their faith commitment to peaceful living, the Brethren strongly support the separation of church and state and oppose any measures which would invite governmental supervisicn of matters of conscience.

If enacted §1012 of the Tax Reform Act of 1985 (H.R. 3838) will result in the taxation of the church pension and welfare benefits boards. These boards, some of which have been in existence for more than two centuries, are carrying out the churches' spiritual task of providing for their needy and retired ministers and denominational employees. Therefore, the church pension boards are an integral part of the mission and ministry of the churches. Taxation of these church boards is tantamount to taxation of the churches themselves and as such constitutes a radical departure from the traditional interpretation of church-state separation.

As noted, church pension boards have been providing retirement and welfare benefits to their ministers and lay leaders for centuries. Congress has acknowledged their central role in the life of the church and has provided them with tax exemption since the inception of the income tax.

Congress through the provisions of the Internal Revenue Code has never sought to define the term "church." This reticence is proper in that any attempt to formulate a single definition would be fraught with danger. Determinations of whether or not an organization is a church are best made on a case by case basis.

Notwithstanding, this Senate committee has clearly indicated its intent that the term "church" includes "organizations which, as integral parts of the church, are engaged in carrying out the functions of the church **whether as separate corporations or otherwise.**" S. Rep. No. 1622, 83rd Cong., 2d Sess. 30 (1954) (emphasis added). The committee further stated, "It is believed that the term 'church' should be all inclusive." Ibid.

In addition to the above-mentioned Senate report, this committee has given other indications that the term "church" should be broadly defined in such a manner as to include the pension and welfare benefits boards. In 1980, in connection with the amendment of §414(e) of the Code concerning "church plans," the following colloquy between Senators Talmadge and Long took place:

> MR. TALMADGE: Mr. President, I understand that many church plans are maintained by separately incorporated organizations called pension boards. These boards have historically been considered by church denominations as parts of their church. May I ask whether the bill would enable a church pension board to maintain a church plan?
>
> MR. LONG: Yes. I concur that a pension board that provides pension or welfare benefits for persons carrying out the work of the church and without whom the church could not function is an integral part of the church and is engaged in the functions of the church, even though separately incorporated. Cong. Rec., July 29, 1980 (daily ed.), at S10167.

Although it is the **sole prerogative** of the church to define its mission and ministry, these statements clearly demonstrate that the Senate Finance Committee considers the church pension boards to be part of the churches themselves notwithstanding their separate corporate status. These church boards are separately incorporated solely in order to protect employee assets from the creditors of other church organizations. Separate incorporation has little to do with the actual polity or composition of the church, and this committee has recognized that fact.

In light of the fact that the church pension and welfare benefits boards are an integral part of the churches themselves, §1012 constitutes an unprecedented imposition of taxation on the churches. It is the position of the Baptist Joint Committee on Public Affairs and the Church of the Brethren that such a tax would be violative of the First Amendment and, therefore, unconstitutional.

The United States Supreme Court has consistently held that government programs or statutes leading to excessive entanglement between church and state are violative of the First Amendment to the United States Constitution. Aguilar v. Felton, ____ U.S. ____, 105 S.Ct. 3232 (1985). Taxation of the church boards will require continual surveillance, monitoring, periodic investigations and audits resulting in an "impermissible degree" of entanglement. See Walz v. Tax Commission of the City of New York, 397 U.S. 664, 675 (1970). "Elimination of exemption would tend to expand the involvement of government by giving rise to tax valuation of church property, tax liens, tax foreclosures, and the direct confrontations and conflicts that follow in the train of those legal processes." Walz, supra, at 674. Although the Court in Walz does not expressly hold that taxation of churches would violate the First Amendment, it clearly suggests this possibility by the above-mentioned statements.

Congress recognized the dangers of entanglement between church and state in 1974, when it passed the Employee Retirement Income Security Act of 1974 (ERISA). An express exemption for "church plans" as defined in §3(33) of ERISA was provided by Congress for fear that application of the Act to the churches would violate the First Amendment. In addressing the exemption of "church plans," this committee made the following statement:

> At the option of an exempt church (or of a convention or association of churches), plans covering its employees may be included in the insurance coverage. The committee is concerned that the examinations of books and records that may be required in any particular case as part of the careful and responsible administration of the insurance system might be regarded as an **unjustified invasion of the confidential relationship that is believed to be appropriate with regard to churches in their religious activities.** However, if the church itself has determined to consent to such examinations, to the premium tax payments, and to the contingent employee liabilities, then it may elect to have the insurance program apply to its plan or plans.... S. Rep. 93-383, 93d Cong., 1st Sess. 81 (1973) (emphasis added).

Perhaps the most compelling reason for exempting church boards from taxation lies in the potential for state regulation or control of religion. In the words of Mr. Justice Douglas:

> The power to tax the exercise of a privilege is the power to control or suppress its enjoyment.... Those who can tax the exercise of [a] religious practice can make its exercise so costly as to deprive it of the resources necessary for its maintenance. Murdock v. Pennsylvania, 319 U.S. 105, 112 (1943).

Put more simply, "The power to tax is the power to destroy." See McCulloch v. Maryland, 17 U.S. 316 (1819).

Apart from the significant questions of constitutionality, §1012 will undoubtedly engender conflict and confrontation with the churches and will at the very least lead to a quagmire of litigation. Enormous sums of time, energy, and money will be expended by both the government and the churches as the legality of §1012 is tested. It is hoped that this committee will prevent this unfortunate scenario from occurring.

History demonstrates that both church and state are healthiest when the two are allowed to function apart from each other. Although there can never be absolute or total separation, there should be an attitude of neutrality on the part of the state with regard to religion. Tax exemption of churches serves to maintain this neutrality. In the words of Mr. Justice Brennan:

> ...the symbolism of tax exemption is significant as a manifestation that organized religion is not expected to support the state; by the same token the state is not expected to support the church. Walz, supra, at 691.

For the above-mentioned reasons, we urge this committee to reject §1012 of H.R. 3838 or to create an exception for "church plans" as defined in §414(e)(3) of the Internal Revenue Code (see the attached proposed amendment to §1012). Such an exception would solve the problems of entanglement created by §1012 while at the same time complying with the requirements of the establishment clause of the First Amendment.

Respectfully submitted,

Oliver S Thomas

Oliver S. Thomas
General Counsel
Baptist Joint Committee on
Public Affairs

Leland Wilson

Leland Wilson
Washington Representative
Church of the Brethren

Proposed Amendment to
§1012, Tax Reform Act of 1985

A new paragraph (6) is added to new section 501(m), as follows:

> "(6) SUBSECTION NOT TO APPLY TO CERTAIN CHURCHES, ETC. - This section shall not apply to a church or to a convention or association of churches, including an organization described in section 414(e)(3)(A) and an organization described in section 414(E)(3)(B)(ii) which, but for this subsection, is exempt from tax under section 501."

B

INSTRUMENT CORPORATION

[illegible] N.W. 29 STREET
MIAMI FLORIDA 33142

February 10, 1986

Attention: Betty Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Building
Washington, DC 20510

Dear Senator Packwood:

We are all Americans and we all should stop the bickering and realize we must sacrifice something individually.

The House-passed version of tax reform is anti-growth and anti-jobs. I urge the Senate to set aside tax reform for now, and turn its attention to the nation's twin deficits -- spending and trade.

I am requesting that you please include my comments in the written hearing record.

Respectfully yours,

BARFIELD INSTRUMENT CORPORATION

James W. Barfield
Chairman of the Board

bl

cc: The Honorable Paula Hawkins
The Honorable Lawton Chiles

BRANCHES: ATLANTA GEORGIA • WINSTON SALEM NORTH CAROLINA • DETROIT MICHIGAN • HOUSTON TEXAS • WASHINGTON D.C.

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STATEMENT OF BELLSOUTH CORPORATION
ON THE TAX REFORM ACT OF 1985,
HEARINGS OF THE U.S. SENATE
COMMITTEE ON FINANCE,
FEBRUARY 6, 1986

BellSouth Corporation ("BellSouth") welcomes the opportunity to file with the Finance Committee this statement for the record setting forth our views on the capital formation provisions of H.R. 3838, the "Tax Reform Act of 1985" (the "Bill"), as passed by the House of Representatives on December 17, 1985.

BellSouth is one of seven regional holding companies formed as a result of the divestiture of the American Telephone and Telegraph Company. It is the largest of the regional companies with $25 billion in assets and approximately 92,000 employees. Through its two telephone operating companies, Southern Bell Telephone & Telegraph Company and South Central Bell Telephone Company, BellSouth furnishes local and exchange access communication services to residence and business customers in nine southeastern states. Other principal subsidiaries are engaged in directory and Yellow Pages publishing, cellular mobile telephone service, and management of telecommunications equipment sales and service.

BellSouth supports the general concept of tax reform that provides for fairness, simplicity and economic growth. However, BellSouth is quite concerned about the impact of the Bill on capital formation even with the proposal to reduce income tax rates.

BellSouth is opposed to the enactment of the Bill principally because of the adverse impact the capital formation provisions of the Bill would have on BellSouth and its subsidiaries, on our customers and on the economic development of the nation. We are convinced that the replacement of the present depreciation system, the repeal of the investment tax credit, along with the requirement that production costs be capitalized, would increase the cost of productive machinery and equipment for American industries and would hurt the ability of U.S. industries to compete in domestic and international markets. Increased obstacles to competition would further deteriorate an already difficult trade situation.

Capital Formation Policy

In 1981 the Congress enacted the present Accelerated Cost Recovery System (ACRS). Congress substantially eroded these benefits in subsequent legislation. The Bill would not only eliminate the capital formation incentives remaining in the 1981 legislation but would make the U.S. capital cost recovery system for investment in machinery and equipment next to last among 15 competing industrial nations.

It is essential that the tax code provide an adequate, realistic capital recovery system so expenditures are recovered at a rapid rate to provide funds for further investment. Funds generated by capital formation incentives are a primary source of financing for BellSouth's capital expenditure program. Any reduction in these incentives could require additional borrowing and could result in an increase in the telephone rates charged to our customers.

BellSouth supports a national tax policy that continues the investment tax-credit and provides for depreciation schedules that mirror competition and technological realities both global and domestic.

Investment Tax Credit

The investment tax credit is very important to BellSouth and its repeal would have a serious, adverse impact on us. Our capital expenditure program was $2.6 billion last year with most of the acquisitions qualifying for the investment tax credit. The credit was added to the tax laws in 1961 to provide a stimulus for industry to modernize its plant and equipment so as to provide jobs, increase productivity and enable us to become more competitive. The credit is serving the purposes for which it was enacted.

Over the past six years, BellSouth has expended approximately $16 billion for plant and equipment to meet the challenge of providing state-of-the-art communication services. The investment tax credit has provided an important source of funds for our capital expenditure program and the loss of the credit would create significant increases in our financing requirements. The availability of the credit as a source of funds has also allowed us to charge our customers lower telephone rates than would otherwise be the case if we had borrowed the funds and passed the interest costs to our customers. The proposed repeal of the investment tax credit is the single most damaging provision in the House bill for BellSouth and we feel that present law should be retained.

Depreciation

The Bill also would reduce capital formation incentives through introduction of the Incentive Depreciation System ("IDS"). Under the current Accelerated Cost Recovery System ("ACRS"), telephone distribution plant (commonly referred to as outside plant) is classified as 15-year public utility property. Under the Bill, outside plant would be assigned to class 8 with a recovery period of 25 years.

IDS is actually a disincentive when compared with the life prescribed for ratemaking purposes, approximately 19 years for BellSouth. The recovery period proposed under IDS is unacceptable, particularly in view of the fact that depreciation recovery in the ratemaking process traditionally has been viewed as grossly inadequate for telephone plant.

IDS also ignores the technological innovations currently underway in outside plant. In recognition of intense customer demand for a telecommunication network with greater capacity and increased reliability, utility companies are installing fiber optic transmission cables to keep the network abreast of the Information Age. The current generation of fiber optics is estimated to have a technological life of five years, in contrast to the 25 year life proposed under IDS. Deployment of modern technologies introduces efficiencies such as reduced maintenance expenses, benefiting all customers in the form of more reliable service and ultimately lower telephone rates.

In order to be competitive in the communications market, investments must be made in technology which increases productivity. If BellSouth is to recover the investments being made in the latest technology, the capital recovery periods contained in the Bill must not be longer than 15 years as provided in present law.

Production Costs

The telephone industry has a long history of self-constructing property used in providing customer service. The Bill would reduce capital formation by enacting uniform rules for capitalizing interest and production costs applicable to self-constructed assets.

Under current law, construction-period interest and taxes attributable to real property must be amortized over ten years but are deductible with respect to personal property. Payroll taxes, fringe benefits and indirect costs generally are deductible when incurred.

BellSouth reduces telephone rates for the associated tax benefits as interest and production costs are incurred. Accordingly, the requirement to capitalize items which, heretofore, have been expensed would result in higher telephone rates.

Effective Dates

The effective dates in the Bill along with the separate House and Senate resolutions regarding these dates have created large scale uncertainty among taxpayers. This uncertainty, in turn, has had a detrimental impact on capital investment decisions. BellSouth believes all provisions should have a common, prospective effective date. This would provide a stable foundation for business planning.

Normalization

Under current law, BellSouth does not reduce telephone rates in the current period for capital formation incentives experienced in the early years of an asset's life. Instead, tax benefits are "normalized", i.e., reflected in telephone rates over the life of the related asset. This ensures that investment incentives are shared between both current and future ratepayers. Otherwise, tax benefits would result in immediate rate reduction that would be paid for by higher telephone rates in later years.

Under the Bill, normalization would be required for regulated utilities, similar to the rules currently provided under ACRS. In addition, normalization rules would be retained for any unamortized investment tax credit and any excess in deferred taxes resulting from a decrease in income tax rates.

BellSouth supports the normalization provisions in the Bill. Continuing normalization would preserve telephone rate stability and ensure that public utilities continue to benefit from capital formation incentives.

Alternative Minimum Tax

The Alternative Minimum Tax (AMT) provision of the Bill is troublesome and should be thoroughly reviewed. Although

BellSouth would not be subject to AMT in its present form, it should be noted that the AMT could negate the capital formation incentives in the Bill.

BellSouth also is concerned about the administrative burden of computing the tax. In addition, normalization language must be added for public utilities to ensure that the AMT is not considered when computing deferred taxes.

Conclusion

BellSouth serves the southeastern region of the nation where the population is growing 40 to 50 percent faster than the U.S. average. BellSouth expects the region's strong economic growth to continue. However, tax legislation which lacks adequate capital formation incentives, such as that contained in the Bill, would have an adverse effect on business in our region and thus on our company.

We support the general concept of tax reform including specific goals such as a reduction in tax rates. However, tax reform should not impair job formation, hinder technological innovation, restrict economic growth or reduce international competitiveness.

Capital formation incentives impact the cost and quality of our service. They are vital to future investments for plant expansion and modernization to keep pace with the growth and demand for our services.

Last year the regulated telephone industry invested over $17 billion in new plant and equipment. The industry would be severely burdened by any change which would make it necessary to raise between $4 and $5 billion from outside capital markets. This would not be in the best interests of the economy, shareholders or ratepayers. Therefore, BellSouth does not support the enactment of the Bill as passed by the House.

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BERRY COLLEGE
[illegible]
[illegible]
Office of the President

February 17, 1986

Senate Finance Committee
Senate Dirksen Office Building
Washington, D.C. 20510

Gentlemen:

I would like to express my support for the testimony presented recently to the Senate Finance Committee by James G. MacDonald of TIAA-CREF.

It is very important that this tax-exempt retirement system for educators be preserved. Proposed changes in the system's status would treat higher education's pension program unfairly since TIAA-CREF would lose exemptions which would continue for virtually all other pension funds.

These changes would reduce the pension benefits of those involved in higher education and therefore harm the educators whose work is so vitally important to our nation's future. I urge the Senate Finance Committee to work to retain the tax-exempt status of this important retirement system.

Sincerely,

Gloria Shatto

Gloria Shatto
President

jh

cc: Congressman George Darden
Senator Mack Mattingly
Senator Sam Nunn

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STATEMENT OF
ROBERT A. BEST
PRESIDENT, BEST ASSOCIATES, LTD.
BEFORE THE SENATE FINANCE COMMITTEE
ON TAX REFORM

Once again, the Senate Finance Committee has the difficult and somewhat thankless responsibility of trying to reconcile the apparently contradictory goals of making our tax laws: fairer and more equitable; simpler and easier to understand; economically beneficial to our citizens, their jobs, incomes, savings and investments.

My testimony does not argue on behalf of any private interest, but attempts to lay out a direction which I sincerely believe will be in the public interest. That direction is based on the need for reconciling the goals of: (1) simplicity; (2) economic growth; and (3) equity -- consistent with the budgetary and national security requirements of the United States as well as its international competitive position -- no minor feat. Senator Roth's proposal, in my view, best accomplishes the reconciliation.

Before I give the reasons for my belief that the Roth bill best accomplishes the reconciliation of national goals, permit a hopefully not altogether irrelevant digression on the *tax reform process*. For many years as the Chief Economist of this Committee, I gave considerable thought to the reconciliation of national goals. At times, frankly, I wondered whether it was really possible to reconcile all these goals; whether, in fact, if not in theory, the process was so democratic, so subject to conflicting private and public pressures, it could not really achieve anything more than further complication and confusion. With the advent of "open sessions" and the political dynamism of PACs, I frankly wondered whether "reform" was not just another code word which became an indelible mark in our political lexicon, but which lacked even a modest definition or meaning.

My beloved Chairman, Senator Long, was wiser than we knew when he said, in his inimitable manner, that reform means: "Don't tax you, don't tax me, tax the man behind the tree." The man behind the tree never really showed himself. And so the tax reform exercises often became an exercise in frustration -- long and tedious and in the end the Code seemed at least as complicated as before. But, the laborious exercises did keep the lawyers and accountants busy, justified the existence of many consultants, and created a number of fine paying "service jobs" which at least in part made up for the jobs which our nation lost in our basic industries -- an honest, if not entirely self-serving assessment.

Tax reform did not really harm the campaigns of the members on the tax Committees, except in one case. One very conscientious former member of this Committee tried his darnest to establish the principle that everyone should pay his or her fair share of taxes. Seizing the initiative in what appeared to be a politically popular and altogether equitable cause, this member sponsored a "minimum tax" to ensure that everyone paid something. He made only one mistake. He tried to perfect his own "loophole closing amendment." In the perfection process, he lost an election on the grounds -- somewhat unfairly I thought, even in politics -- that he was "opening a loophole." Anyway, he became a judge and now has more time to devote to the finer things in life -- playing golf at Burning Tree. The lesson from that reform exercise may be *don't try to perfect your own "loophole closing" amendment.*

After giving the matter a considerable amount of thought I came to the conclusion that what this nation needed to achieve the apparently conflicting goals it faced was a *gradual transition* toward:

- a maximum corporate and individual tax rate of about 20 percent, which would enable Congress to eliminate most of the current credits, deductions and allowances of current law, combined with ,
- a consumption tax (call it business transfer tax) gradually increasing to no more than 10 percent which would provide the Federal government with sufficient revenues to meet our current and foreseeable security interests and domestic social and economic responsibilities.

As it appears almost inevitable that the Congress, with the Administration's blessing, will severely raise the cost of capital, I believe that in order to avoid a major recession, you will have to reduce the individual rates far beyond the House bill or the Administration's proposals, so that the nominal rates and the effective rates are much closer to one another. But, if you do that, there is a revenue shortfall problem. Thus, a tax on consumption (business transactions) becomes important. That such a tax would make our nation more competitive internationally and, in fact, substitute for a much needed exchange rate realignment, which will not happen otherwise despite the newfound enthusiasm for it in the Treasury and some foreign financial centers , is not a minor consideration with the prospect of $150 billion trade deficits for years to come.

The Chairman has tried to see where a consensus may be found by a Committee meeting with the President and then a retreat with the members. That is a great initiative. Politics is a tough business; if there is no basic effort at working toward agreement an overall national interest consensus approach, it becomes frustrating in the extreme. If you can't agree on the basic goals at the beginning of the process and have some consensus on a direction, it will be impossible to do anything more than further complicate an already overly complicated system.

Both the Administration and the House- passed version of tax reform are likely to result in significant increases in inflation as the sharp increases in business taxes are passed forward in the price structure and/ or a loss of competitiveness as more businesses move offshore to take advantage of lower costs of production. Once, the Administration started the process of taxing Peter to pay Paul-- Peter being business and Paul being individuals -- it was inevitable that the House would tax Peter a lot more than the Administration would like. In some ways the situation is analogous to the first Nixon tax reform which resulted in the 1969 Act. That Act eliminated the investment tax credit. Some, but not all, in the business community warned that this would lead to a sharp decline in investment, jobs and incomes, risking the wrath of the newly elected Republican Administration. The naysayers were viewed as self serving and the law as signed did in fact eliminate the ITC. After the bill passed, investment fell off, the country was in a recession and, the Administration submitted another bill which made the investment tax credit a permanent part of the tax laws. It was one of the quickest reverse field plays that one Administration engineered within a two year time frame. The 1971 Act made the Investment Tax Credit permanent!

Now the Congress is about to make the ITC permanently impermanent and reduce ACRS and many other benefits which do in fact reduce the cost of capital, and encourage risk taking and investment. If you're going to do that, and it appears, politically, you are in a box and will inevitably tax Peter to pay Paul, then I submit the best tax is not on capital, income and investment but on consumption.

The President has apparently rejected a consumption tax. If he is taking that position because he wants to gain as much leverage as possible to squeeze out real spending cuts, that is one thing. In the light of the hoped for new self enforcing budget discipline, his current rejection makes tactical political sense. However, come April and the $144 billion budget deficit target cannot be met after all the pruning, slicing and terminations of programs because it is discovered that the economy is not growing at four percent and will not grow at that unprecedented rate for five years in a row, he will have different political choices. At that point, some in Congress will try to terminate his major defense programs. I don't think the Social Security COLA fight will be back on the table. If, at that point, the consumption tax combined with a lower income tax rate structure is still viewed as another way of insuring the "tax and spend" habits of our government, I see an end to tax reform and a lot of useless finger pointing. I understand and share the antipathy for new taxes. I understand the deeply held conviction of those who view any tax with grave suspicion as a way of evading the Federal Government's responsibility of reducing Federal spending, which is now running at about 25% of GNP despite all the budget cutting efforts of the past five years. Frankly, Congress exceeds the President's budget requests, I don't understand why the veto authority is not weild more frequently. Since, Fiscal Year 1980, according to Senator Dominici, there has been an increase of $132 billion (99 %) in national defense; $169 billion in new spending for domestic entitlement programs (an increase of 60%) and an additional $26 billion in domestic discretionary spending (a 17% hike). Even while signing the Gramm--Rudman--Hollings legislation, the President signed all the spending bills even though they contained in the aggregate $40 billion more in domestic spending than he wanted and $30 billion less for defense.

With the apparent new discipline put into the budget process by Gramm -- Rudman --Hollings, a consumption tax combined with income tax reductions is, in my view, meritorious in its own right for domestic, international security and international economic goals.

Domestically, it is the best way of really reducing income and profits taxes to stimulate savings and investment; it will create an incentive for American business to hold down value added (costs). A November 1979 Report of the Republican Policy Committee on VAT, stated:

> The institution of a VAT system could enable Congress to reduce the top rates for both individual and corporate taxpayers to more reasonable levels, thereby restoring investor confidence in business and enabling business management to base decisions primarily on business motives.

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On the issue of progressivity this Report stated:

> Admittedly, VAT without special provisions is not a "progressive" tax. However, upwards of 100 million Americans are already paying an even more regressive Social Security payroll tax. Additionally, existing income tax laws create many instances of regressivity. Many higher income people are successful at avoiding taxes because they can afford "professional " tax advice while many lower income taxpayers do not take advantage of even elementary tax avoidance possibilities. The unintended result is regressivity.

A VAT is a far less regressive tax than a payroll tax or the cruel tax of high real interest rates which currently exist and threaten to skyrocket if the budget deficits are not soon brought under control. Any tax can be made more or less progressive by a combination of exemptions and credits so the consumption tax cannot be fairly branded before it is prepared for a final showing.

Internationally, the trade and current account deficits are not sustainable. No great nation can keep losing industrial capacity, going deeper and deeper into debt and borrowing from its creditors to pay its bills. Sooner or later there will be a day of reckoning and the longer we are on the dizzying merry-go-round of: **budget deficits -- high real interest rates -- capital inflow -- unreal high dollar exchange rates -- trade deficits -- reduction of basic manufacturing industries -- underemployment of resources** -- the longer this vicious cycle continues, the more painful will be the adjustment to real life later on.

A Finance Committee staff memorandum to Senator Long on the Value Added Tax dated February 1, 1979 indicated that :

> In general, the application of a VAT to imports and its rebate on or nonapplication to exports is most defensible in terms of the GATT, and most likely to raise significant amounts of revenue, if a mandatory VAT is applied to a broad range of products.

The revenue potential at the time both the Republican and Democratic memoranda were written was about $7 billion for each percentage point of a VAT. It is estimated that a VAT with liberal exemptions would currently yield substantially more revenues than that, about $15 billion for each percentage point.

From an international security point of view, the rebuilding of our defenses still requires substantial outlays for defense. Americans want and are willing to pay for a strong defense. They leave it up to the judgment of you in government as to what that means and trust you will deal strongly with the rip off artists in the defense procurement world. But the kind of reductions that the Gramm -- Rudman bill calls for -- given the apparent sacredness of Social Security COLAs and the increasing deficit drive of interest payments on the debt -- the defense budget will not escape a meat axe unless there is some new source of revenue.

People may argue that $200 billion budget deficits and $150 billion trade deficits may *look like* "Voodoo economics," but let's face it, we are enjoying the most fruitful economic period in the postwar history with 11 million new jobs since 1981 and an inflation rate that is well below average.

Why fix something that ain't broke? That is persuasive on its face, but it is the Administration which is proposing an elimination of the very incentives to invest which made the "Voodoo economics" work. There was nothing "Voodoo" about it at all. We have experienced, over the past five years, the benefits of the three pillars of Reaganomics: (1) lower taxes on income, savings and investment; (2) less regulation; and (3) a stronger defense. These pillars , however, would have crumbled under the crushing weight of double digit interest rates if our Federal budget deficit had not been financed, in large part, by foreign capital. What would have happened if for any reason, foreigners had decided that the American dollar was not the best place to invest their capital? Would we have had the same kind of growth and inflation record? I doubt it very much.

My point is that if you are going to eliminate those incentives, the income and corporate taxes must be brought down drastically, and the only responsible way of doing that without creating a major mess domestically and internationally, is through the imposition of a consumption tax of some kind. So the President may be saying Nyet now but if you pass his proposal or the House bill and you are looking at a major recession in the last half of this decade, beginning perhaps before the November elections, then you will be back -- that is those who are reelected -- trying to put Humpty Dumpty back together again. I doubt that this President has any more of a crystal ball than his predecessors. Though he is a most remarkable and loveable man with clear and noble values, and yet he and his advisors may not fully appreciate that if you raise the costs of capital to American business by anything like his proposal or the House bill, you will kill the goose that laid the golden egg.

Once you kill the goose, it takes a gestation period of at least two years before another goose is created.

That statement is not intended to be critical -- no one really knows the precise interrelationships between the elimination of the investment incentives and the short, medium and long-term effects on the economy, but one doesn't have to be a trained economist to realize that if you take away an incentive there will be a lot less activity. I remember a former Chairman of Merrill Lynch testifying before members of this Committee on the importance of reducing the capital gains tax for risk taking and investment, broadened equity ownership and jobs. Later, as Secretary of the Treasury Don Regan fought for the ACRS and other business incentives. They worked well and he deserves a lot of credit for his past fights for these incentives. But if they worked well over the past five years, how can we be sure that eliminating some and drastically curtailing others will be in our national interests for the next five years? I am a little perplexed about the logic and philosophical consistency of the Administration's cases in 1981 and 1985. Has the patient really changed so much that what was good for him in 1981 and what made him so healthy -- despite the deficits -- is now the wrong medicine? I would prefer to achieve the goal of tax neutrality by a gradual transition toward a consumption tax than by a re-imposition of taxes on American business which can't compete very well under the present level of taxes.

Thank you for your patience. Good luck.

The Black & Decker Corporation
701 East Joppa Road
Towson, Maryland 21204
301 583 3943

Laurence J. Farley
Chairman of the Board and Chief Executive Officer

BLACK&DECKER.

For Submission:
Hearing Record of 2/4/86

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STATEMENT OF THE BLACK & DECKER CORPORATION

TO: Senate Finance Committee

SUBJECT: THE IMPACT OF TAX REFORM PROPOSALS ON THE INTERNATIONAL COMPETITIVENESS OF U.S. INDUSTRIES

The Black & Decker Corporation is a leading global manufacturer and marketer of power tools, household products and other labor-saving devices. We are headquartered in Towson, Maryland. Approximately 40% of our sales are outside the United States and business overseas is conducted through approximately 40 foreign subsidiaries in over 50 countries. Manufacturing is conducted at 7 plants in the U.S. and in Brazil, Canada, England, France, Germany, Italy, Mexico, Singapore, and Switzerland.

Black & Decker faces competition all over the world from global companies, must notably from Japan and Germany. Foreign capital goods producers increasingly are penetrating U.S. markets and are gaining a growing share of world markets. This trend will continue until the international competitive position of U.S. industry improves substantially.

However, the playing field is not level. Our competitors' profit margins and return on assets are, in many cases, lower than that required by the shareholders of a U.S. company such as Black and Decker. Furthermore, the rules of competition are stacked against U.S. companies which must operate under extra territorial codes of conduct that do not exist for many of our major trading partners.

The U. S. trade deficit is now at the $150 billion a year level, and yet the government, instead of encouraging U.S. companies to develop foreign markets, is proposing strange and perverse tax changes that will further inhibit the ability of U.S. companies to compete overseas.

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Preserving America's competitive position in the world must now be recognized as a national priority. In today's global competitive world, we can no longer ignore the incentives or disincentives our tax code provides for the ability of American business to compete. To a much greater extent than we, our major trading partners use their tax codes together with other government policies to give positive incentives for investment, savings and exports.

Our specific comments to certain of the objectionable provisions of the tax proposals are as follows:

Foreign Tax Credit Limitation

Black & Decker has been in an excess foreign tax credit position since the inception of the Section 861 allocation rules in 1977. Every year we have had excess foreign tax credits expire before they could be used during the short, five-year carryover period. However, Black & Decker has never shifted investments from the U.S. to foreign countries simply on the basis of tax considerations, such as generating additional foreign source income with which to use excess foreign tax credits.

The Administration appears to be of the opinion that U.S.-based multinationals design their worldwide investment programs solely with reference to U.S. tax laws. This simply is not the case. Taxes are a cost of doing business and, as such, reasonably are a factor in any business decision. However, they are but one factor among a host of considerations, such as (1) access to foreign markets; (2) labor costs; (3) size of the market; (4) transportation costs; (5) duties; (6) exchange controls; (7) political stability; (8) infrastructure; and (9) financing.

Black & Decker's foreign competitors in Japan and Germany are subject to very favorable tax rules in their home countries on foreign income. For example, Japanese companies use the "overall" foreign tax credit limitation. Furthermore, Japanese companies can deduct reserves for possible losses calculated as a percentage of its investment in foreign subsidiaries. Also, a portion of royalties received by Japanese companies from overseas licensing is tax-exempt. Foreign dividends received by German companies are generally exempt from German income tax if received from a treaty country. Germany also exempts dividends received from subsidiaries located in certain developing countries, even if the subsidiary pays no foreign income tax.

continued ....

The "per country" proposals will further aggravate Black & Decker's ability to avoid economic double taxation on the repatriation of foreign earnings. If Congress is interested in fostering exports and encouraging the repatriation of foreign earnings, it is recommended that the foreign tax credit carryover period be extended to 15 years (which is the rule for net operating losses and business tax credits). Secondly, the ordering rule for foreign tax credits should parallel those for general business credits. Any carryover credit should be taken into account before the current year's credit.

Allocation of Interest Expense

We strongly urge that the proposal be dropped which requires interest expense to be allocated on a consolidated basis using only a balance sheet method.

Such a proposal will further exacerbate the excess foreign tax credit position that many companies, such as Black & Decker, find themselves. It will result in economic double taxation of foreign earnings that are remitted as dividends, and undoubtedly, will worsen this country's balance of payments deficit by discouraging the repatriation of such earnings.

This proposal will be particularly harsh to small and under-capitalized companies which are trying to develop an export business, but do not have access to the equity market for the purpose of reducing their debt.

Our research has not found any industrialized country which allocates interest expense to foreign source income in computing their foreign tax credit limitation. In the global marketplace, this proposal will result in an additional cost of doing business that Black & Decker's foreign competitors do not have.

The proposal under the asset method to account for stock investments under the equity method has no economic justification or tax equity and can only be characterized as a revenue raising measure. To the best of our knowledge, this is the first time the equity method of accounting will appear in the tax code. It can be economically justified only to the extent that a provision is added offsetting the 861 allocation amount by credits for interest expense incurred by foreign subsidiaries in financing their own operations.

continued ....

Subpart F Proposals

Several of the proposals to expand the reach of Subpart F income and constrict tax deferral for CFC earnings violate the legislative purpose of Subpart F and will have a real negative impact on the competitive stance of U.S. owned foreign businesses vis-a-vis foreign owned foreign businesses.

The enactment of Subpart F in 1962 for the purpose of curbing artificial tax deferral transactions, was guided by the principal enunciated in the Senate Finance Committee, recognizing "the need to maintain active American business abroad on an equal competitive footing with other operating businesses in the same countries." This was one of the reasons why a de minimus exemption was legislated for passive income less than 30% of total gross income (restricted to 10% in 1975). A further restriction to 10% of foreign earnings will result in Subpart F taxation of minor amounts of interest income of many Black & Decker foreign companies that have cyclical cash need requirements coupled with marginal profitability. The proposal will have the punitive effect of requiring this U.S. tax liability to be paid from U.S. source earnings unless the U.S. parent is willing to incur sometimes high foreign withholding taxes on dividend repatriations.

The existing de minimus rule is flexible enough to permit the retention of sufficient cash by foreign subsidiaries to meet cyclical working capital needs without permitting abusive retention of idle cash. Although other countries, such as the UK, Japan and Germany, have Subpart F type rules, none of these countries attempt to tax interest earned by foreign subsidiaries engaged in genuine manufacturing or marketing businesses. Here, again, this proposal has as its objective revenue raising without any concern for principles of equity, simplicity or economic neutrality.

* * * * *

In summary, these proposals will (1) discourage the repatriation of earnings from foreign subsidiaries, thereby aggravating our country's balance of payments, (2) will place U.S. companies at a disadvantage in relation to their foreign competitors, and (3) impose enormously complicated and costly recordkeeping and compliance burdens on multinational taxpayers. Marginal worldwide tax rates for U.S. business doing business abroad will increase disproportionately to the benefit of the proposed reduction in rate.

The U.S. has a large negative trade balance to redress in the context of having become a debtor nation for the first time in modern history. Any tax changes need to be cognizant of this difficult economic environment and be appropriate to the economic imperatives of the late 1980s.

Black & Decker urges support for The Republican Alternative offered on December 3, 1985 which accomplishes the President's objectives without sacrificing the ability of U. S. business to compete in the international marketplaces.

Respectfully submitted:

Laurence J. Farley

Laurence J. Farley
Chairman of the Board
Chief Executive Officer

/elh

60730

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AREA CODE [illegible] TELEPHONE [illegible]

Blair Mills, Incorporated

TURKISH TOWELS, WASH CLOTHS
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BELTON, SOUTH CAROLINA 29627

SELLING AGENT:
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P.O. BOX 370
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[illegible] FIFTH AVENUE
NEW YORK, NEW YORK 10016
PHONE (212) [illegible]

February 6, 1986

Attn: Betty Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Bldg.
Washington, D. C. 20510

Dear Senator Packwood:

House of Representatives Bill #3838 has recently passed the House and is now going to the Senate for consideration. The National Assocation of Manufactures along with Blair Mills, Inc., sees HR 3838 as a flawed proposal. Our suggestion would be to set aside tax reform for the time being and concentrate on the more important spending and trade deficits.

I urge that tax reform be set aside for now due to the anti-growth and anti-job nature of the House passed version of tax reform.

I would also like to request that these comments being included in the hearing record.

Thank you for your attention.

Sincerely,

Blair Rice, Jr.

Blair Rice, Jr.
Chairman/CEO

CC to: Senator Strom Thurmond
Senator Ernest F. Hollings

B

Borden
DURHAM–SANFORD

General Offices and Plant: Hoover Road / P. O. Box 11555 / Durham, N. C. 27703 / Phone (919) 596-6241

February 7, 1986

Attn: Betty Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Packwood,

I am writing this letter to you to express my opposition to the HR3838 tax overhaul bill, which I understand your committee will begin consideration on.

This bill as far as business is concerned would seem to undo all the excellent goals of the 1981 Economic Recovery Act.

If industry in this country is to stay competitive with other nations we must have a constant stream of investment in new equipment. This is particularly true of businesses such as ours which are capital intensive. With new equipment becoming ever more sophisticated and expensive a small company such as ours needs every break possible to remain up to date. Due in large part to the present tax incentives for investment we have spent approximately 1½ million dollars this year on a fuel conversion project. This project will allow us to fire our bricks with sawdust instead of natural gas or oil. This will not only help reduce our nation's energy deficit, but will provide a market for a waste product that we produce here in the Eastern United States.

I don't say that our present tax law is perfect, but for manufacturing businesses, it is much better than HR3838. I would like to see any new tax law contain more incentive for capital investment, not less. After all, we can't all work at hamburger stands or other service industries. Sombody has got to produce the tangible goods that we use and need.

Please include these comments in your hearing record. Thank you for your consideration.

Yours truly,

BORDEN BRICK & TILE COMPANY

F.K. Borden
President

FKB/mp

Phones: Plant - Sanford, N. C. (919) 776-6130 / N. C. Toll Free 1-800-672-0881

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B

BRITISH EMBASSY.
WASHINGTON, D.C.
TELEPHONE: (202) 462-1340

FROM THE AMBASSADOR

5 February 1986

The Honorable
Robert Packwood
Chairman
Senate Finance Committee
219 Dirksen Senate Office Bldg
WASHINGTON DC 20510

Dear Senator Packwood,

FEDERAL EXCISE TAX ON INSURANCE PLACED ABROAD

On 17 December 1985, the House of Representatives approved an amendment to the Federal Excise Tax (FET) on insurance placed abroad as part of H.R.3838, the "Tax Reform Act of 1985". This amendment, which was first recommended in the Staff Options prepared by the Joint Committee on Taxation, was not included in the Administration's tax reform proposals. It was included in the House version of the tax reform bill without hearings or an adequate opportunity for discussion.

In the view of Her Majesty's Government, the proposed amendment constitutes a unilateral abrogation of the unconditional waiver of the Federal Excise Tax in the US/UK Double Taxation Convention. The amendment would impose a tax upon insurance premiums written by British insurers, where none is due under the current treaty. If the change were approved, a tax would be due on insurance premiums paid to British insurers to the extent they are reinsured with non-exempt insurers.

The House provision disregards the unambiguous language and legislative history of the waiver by imposing the tax on exempt British insurers who subsequently reinsure a US risk with a non-exempt insurer. In its report on the US/UK Treaty, the Senate Foreign Relations Committee stated :

/". . . no

> "... no US excise tax will be collected if the UK insurer has no US trade or business, regardless of whether or not it reinsures the risk".

In response to a request by the conferees, who rejected this provision during deliberations on the Deficit Reduction Act of 1984, the UK Government has provided materials to the Treasury Department demonstrating that the waiver in the US/UK Treaty should be preserved. In the Conference Report, the Conferees expressed concern that the waiver in the Treaty might allow British insurers to serve as "conduits" for non-exempt insurers seeking to avoid the excise tax.

A study has been provided to the Treasury Department showing that (1) the nature of the UK reinsurance industry, and in particular the way in which risks are "pooled", does not lend itself to "fronting" activity; (2) there is no economic incentive for UK insurers to serve as "conduits" for non-exempt insurers seeking to avoid the tax, since they would be required to assume substantial liabilities in return for only nominal savings of the excise tax; (3) regulations of the UK Department of Trade and Industry create significant barriers to operating a "fronting" company or conduit in the UK, and (4) no evidence of abuse has been found in the US, and a survey by the Association of British Insurers found no instances in which UK companies were used as a conduit to place insurance with insurers in non-exempt countries.

The Treasury Department has also asked whether evidence exists as to the impact of the waiver on placements into the UK. The British Government has not maintained records on US source business, nor on outbound insurance from the UK. However, the US Department of Commerce has records of reinsurance placements from the US to other countries. The data shows that (1) the percentage of increase in US reinsurance ceded to the UK has been significantly less for the four year period after the adoption of the Treaty than for the five year period before its ratification in 1980, and (2) the percentage increase in the UK for the 4-year period after the Treaty's ratification has been less then any other country, except the Latin American Republics, for which data is separately reported by the US Department of Commerce. Both comparisons support the conclusion that the adoption of the waiver in the Treaty has not encouraged the use of the UK as a "conduit" for insurance with non-exempt companies.

Finally, my Government has submitted a study showing that the withholding mechanism proposed by the amendment presents formidable problems of administration. Compliance with the proposed amendment would require UK insurers to develop new and costly record-keeping procedures for US insurance. Because of the experience of British insurers in claiming the refund of the excise tax for the five-year period between the Treaty's ratification and its effective date, British companies fear that the withholding system would result in delays of several years before amounts would be refunded, with the resulting loss of investment returns on these funds for that period.

/Such

Such higher costs would necessarily be passed on to US policyholders, for whom the UK market provides much-needed additional capacity.

On behalf of Her Majesty's Government, I respectfully request that the Senate Finance Committee, under your Chairmanship, reconsider this unfair and unnecessary obstruction to the international insurance industry. We ask that the waiver of the tax in the Double Taxation Convention be preserved.

Yrs sincerely

Oliver Wright

cc : members of Senate
Finance Committee

STATEMENT OF GEORGE BRODE, JR.
FOR THE RECORD CONCERNING
PROPOSED REPEAL OF THE
GENERAL UTILITIES DOCTRINE

My name is George Brode, Jr. I am a sole tax practitioner specializing in Federal income tax matters for closely held corporations and their shareholders in Chicago, Illinois. I have recently acted as Special Tax Counsel to the Illinois State Bar Association and the Chicago Bar Association, past Chairman of the Section of Taxation of the Illinois State Bar Association, past Chairman of the Subcommittee on Redemptions, Committee on Closely Held Corporations, American Bar Association Section of Taxation, author of BNA Tax Management Portfolio 8-4th Corporate Acquisitions - - Planning, and General Editor of a two volume book entitled Closely Held Corporations published by the Illinois Institute for Continuing Legal Education. The following comments reflect my own personal opinions and should not be construed as representing the opinion of any bar association.

POSITION

I believe that Congress should not repeal the General Utilities[1] doctrine. In the event that Congress deems additional revenue necessary, I recommend a modest increase in corporate tax rates to replace the anticipated loss in revenue.

BACKGROUND

The statutory law governing the taxation of corporations and their shareholders in corporate acquisitions have been in place for more than 30 years. A well understood body of case law and enabling regulations have been developed under these provisions. The present proposals on recognition of gain or loss on distributions of property in liquidations (proposed sections 331 through 335 of H.R. 3838 reported by the House Ways and Means Committee on December 7, 1985 at 274 through 291) find

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1/ General Utilities v. Helvering, 296 U.S. 200 (1935) their genesis in a prior proposal known as the "Subchapter C Revision Act of 1985" prepared by the staff of the Senate Finance Committee and issued in May, 1985 (hereinafter the "SFC Proposal"). This SFC Proposal contained a set of statutory recommendations that would (i) modify the rules for structuring corporate acquisitions, (ii) repeal the General Utilities doctrine, and (iii) establish a new way of limiting net operating losses in connection with acquisitions.

Need for an Economic Impact Study

The suggested repeal of the General Utilities doctrine described in both the prior and current bill will result in more tax for closely held corporations (i.e., small family corporations whose stock is not publicly traded on a national exchange) than is now the case under present law. In that regard the SFC Proposal noted that:

> " . . . the impact of repeal of General Utilities (and the consequent need for some form of relief) would fall almost exclusively upon small, closely held businesses, and that large, publicly held corporations would rarely be affected." SFC Proposal, at 63. Based on testimony of John S. Nolan at 148, 151 noted at SFC Proposal, at 6, footnote 24.

In commenting on the prior SFC Proposal, Treasury expressed concerns as to the economic impact of the proposals upon taxpayers. The Honorable Ronald A. Pearlman, Assistant Secretary (Tax Policy), Department of the Treasury at hearings held on September 30, 1985 before the Subcommittee on Taxation and Debt Management of the Committee on Finance of the United States Senate, in commenting on the suggested acquisition proposals and repeal of the General Utilities doctrine, stated, in pertinent part, as follows:

> "We are concerned, however, that enactment of changes of the magnitude suggested by the Staff is for several reasons inappropriate at this time. First, in light of the substantial modifications to the Internal Revenue Code that will be necessary to accomplish fundamental tax reform, we are hesitant to support further extensive changes. Second, the Treasury Department does not believe that the potential economic effect of the Staff's far-reaching proposals have been adequately considered. In this regard, we complement the Committee for soliciting the views of various economists for today's hearing, but we must emphasize that before undertaking major changes in a area as well settled as Subchapter C, these potential effects must be clearly understood. Therefore, with one important exception [net operating loss limitations], we recommend that the Committee defer passage of extensive changes to Subchapter C until fundamental tax reform has been completed, the resulting statutory changes have become understood by taxpayers and their advisors, and the potential economic effects of the Staff proposals have been thoroughly documented."

I believe that while the nature of the relief provisions have been changed, Mr. Pearlman's incisive comments apply with equal force to the present proposals. While the prior bill would have provided relief to shareholders of closely held corporations in the form of an upward basis adjustment to their stock to reflect corporate level tax paid on long held capital assets, the present bill discards that relief proposal and opts instead for a two step approach. First, liquidation of an "active business corporation" would avoid recognition of gain or loss on liquidating distributions of long-term capital assets to the extent of its "qualified stock". The term "qualified stock" means stock owned by 10% or more noncorporate shareholders for at least 5 years (or the life of the corporation, if less than 5 years). Secondly, a general 10% dividend received deduction would apply to all corporations whether publicly traded or closely held.

Repeal of General Utilities would be a revenue raising measure that would secure approximately 4,041 million during the period 1986 through 1990. H.R. 3838, at 291. The proposed 10% dividend received deduction is estimated to reduce corporate taxes by 2,351 million over this same period. H.R. 3838, at 242. It would appear that the cost of repeal of General Utilities would be borne by those liquidating closely held corporations that for one reason or another fail to (i) make distributions with respect to qualified stock,[2] (ii) hold long-term capital assets, or (iii) qualify as an "active business corporation". It is not clear, however, who would receive the majority of the 2,351 million relief reduction during this five year period. One might surmise (absent a documented economic study to the contrary), that since many closely held corporations do not pay dividends, the economic benefits of such relief would flow almost entirely to large publicly traded corporations. So viewed, the suggested proposals appear to be a revenue raising measure with most of the "bill" presented to closely held corporations.

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[2] 2/ Because they have shareholders that own their stock for less than 5 years or own less than 10% of the stock.

Summary Explanation of General Utilities Repeal Provisions

The General Utilities repeal provisions of the bill may be summarized as follows:

1. In general, the General Utilities doctrine would be repealed for distributions of property in corporate liquidations. This would have the effect of reversing the present nonrecognition of gain treatment accorded corporations on liquidating distributions of assets to shareholders under Section 336 of the Code. In addition, the extension of General Utilities to sales of property to third persons by liquidating corporations would also be repealed. This would reverse the long standing rule permitting nonrecognition of gain to a liquidating corporation on certain sales of property to third persons in connection with a plan of complete liquidation under Section 337 of the Code. Thus, a liquidating corporation would be subject to tax on the excess of the fair market value of its assets over its then adjusted basis in those assets.

2. General Utilities would still apply (both for distributions in kind and for certain sales to third parties) to that portion of corporate assets representing stock held by certain noncorporate, 5-year, 10% shareholders if the corporation meets certain active business requirements. This rule would be similar to that presently set forth in Section 311(d) of the Code. However, the General Utilities benefit would be limited to long-term capital gain assets.

3. The General Utilities doctrine would be retained for liquidating distributions of property by subsidiaries upstream into their corporate parent under Section 332 of the Code (except for assets attributable to minority shareholders).

4. The General Utilities doctrine would be retained and codified for distributions pursuant to tax free corporate reorganizations.

5. Conforming changes would be made to Section 338 of the Code, relating to the treatment of certain stock purchases that are treated as an acquisition of assets.

6. An S corporation's Subchapter S election would be retroactively terminated if liquidated without having been a S corporation for at least 3 full years after having previously been a C corporation.

7. Lastly, the bill provides for a 10% dividends paid deduction on a phased in basis. In addition, the dividends received deduction of present Section 243(a)(1) of the Code would be reduced from 85% to 70% for dividends received from

unaffiliated corporate distributors. The 85% dividends received deduction would be immediately reduced to 80% with a phase-in of the remaining 10 percentage point reduction. The present 100% deduction for dividends received from certain affiliated corporations under present Section 243(a)(3) of the Code, would, in general, be reduced to 90%.

DISCUSSION

I question the litany of problems attributed to General Utilities both by the prior SFC Proposal and H.R. 3838 in order to justify adoption of the sweeping proposed change. There have been 12 specific exceptions and limitations to the general rule of Section 311(a), 336, and 337 which codified General Utilities in the 1954 Code. See SFC Proposal at 60, 61 which lists the statutory exceptions. Save for attacking the one tax conclusion of Section 337 of the Code, little, if anything, remains to be chipped away. That Congress should now seek to turn back the clock on Section 337 seems strange in that this question was exhaustively analyzed by both the Supreme Court and Congress. Both came to the conclusion that upon complete liquidation of a corporation, tax should be imposed solely at the shareholder level. This was subsequently modified to permit recapture of depreciation, investment credit, LIFO inventory (each by statute), and previously taxed benefits (by case law) at the corporate level.

Why does Congress now seek to overturn such a well established rule? Ordinarily, Congress has been reluctant to substitute its judgment for that of its Congressional forefathers unless it could be clearly demonstrated that such prior policy created an unintended tax avoidance benefit or created an abuse contrary to an overriding tax policy consideration. Neither appears to be the case in the present situation.

No Abuse Exists To Justify Repeal of General Utilities

Both Congress and the courts have directly authorized a one tax conclusion in connection with a complete liquidation of a corporation. Specifically, since General Utilities was decided by the Supreme Court in 1935, a corporation has been permitted to avoid the payment of tax on a distribution of property to its shareholders in connection with a complete liquidation. Moreover, United States v. Cumberland Public Service Co., 338 U.S. 451 (1950), tacitly reversed the position of Commissioner v. Court Holding Co., 324 U.S. 331 (1945), and held that a corporation could liquidate without subjecting itself to tax at the corporate level notwithstanding that the primary motive for the distribution of property to the shareholders was to avoid corporate tax. Thereafter, Congress in 1954 codified that result by the enactment of Section 337 of the Code which provided that a corporation would not recognize gain or losss on a sale of its property (other than certain recapture items) if it adopts a plan of complete liquidation and distributes all of its assets to its shareholders within 12 months of the date of adoption of the plan.

Proffered Reasons for Change

As its rationale for changing its position on General Utilities and thereby Section 337 of the Code, H.R. 3838 states, in pertinent part, that the General Utilities rule:

> " . . . produces many incongruities and inequities in the tax system. First, the rule may create significant distortions in business behavior. Economically, a liquidating distribution is indistinguishable from a nonliquidating distribution; yet the Code provides a substantial preference for the former." H.R. 3838, at 281.

I respectfully disagree. It would appear that a liquidating distribution in which a corporation sells off its assets to a third party, pays off its creditors in [illegible]der to wind up its affairs, followed by a distribution of the remaining proceeds to its shareholders in complete liquidation is radically different from a nonliquidating distribution in which the corporation remains in operation after the distribution and its shareholders receive such property without changing their position.

The committee report goes on to provide that:

> "A corporation acquiring the assets of a liquidating corporation is able to obtain a basis in assets equal to their fair market value, although the transferor recognizes no gain (other than possibly recapture amount) on the sale." H.R. 3838, at 281.

Once again, I respectfully disagree. A tollgate charge is extracted in connection with a sale of assets. If following the acquisition the corporation is kept alive, tax is paid at the corporate level on the excess of the amount received over the target corporation's adjusted basis in its assets. Conversely, if the corporation is liquidated under Section 337 of the Code, tax is imposed both at the corporate level for recapture items and at the shareholder level on the excess of the amount received by the shareholders over their collective adjusted basis in their stock. Thus, the "price" to be paid to enable the purchasing corporation to secure a stepped up basis in the assets it acquires is a tax paid at either the target corporation's level assuming there were no liquidation following the sale of assets, or a tax paid at the shareholder level in the event a Section 337 liquidation were adopted. In addition, tax would also be imposed at the corporate level on recapture items.

I further disagree with the inferance that because the assets may be ". . . more valuable in the hands of the transferee than in the hands of the present owner" that in some fashion that fact might induce "corporations with substantial appreciated assets to liquidate and transfer their assets to other corporations for tax reasons, when economic considerations might indicate a different course of action." H.R. 3838, at 282. While it is true that certain assets may appreciate in value due primarily to inflation, or that other assets may be nearly fully depreciated, sale of those assets by a corporation will trigger either depreciation, investment credit, or LIFO inventory recapture at the corporate level as well as tax at the shareholder level in the event of a Section 337 liquidation. I believe that it is erroneous to suggest that the present tax Code in some fashion fosters a sale of assets in cases where either the shareholders, the corporation, or both would be required to pay a tollgate charge in connection with such transaction.

Moreover, I strongly disagree with the committee's assertion that the General Utilities rule may be responsible, at least in part, for the dramatic increase in corporate mergers and acquisitions in recent years by artificially encouraging such transactions. H.R. 3838, at 281. As noted previously, the failure to furnish an economic analysis in support of the committee's rationale, places both Congress and taxpayer's representatives on thin ice in discussing the pros and cons of the suggested proposals. Notwithstanding that caveat, I believe that the following observations are clearly relevant:

1. The General Utilities doctrine and Section 337 of the Code have been in the tax law for a number of years. However, only recently has there been a dramatic increase in merger and acquisition activity. This would tend to indicate that other factors are at work to explain the increase in merger and acquisition activity.

2. The bill would artificially discourage asset acquisitions. There are many nontax economic reasons why an acquisition may be structured as a stock acquisition or as an asset acquisition. It can be expected that if this proposed bill became law, purchasers and sellers, strictly from a tax viewpoint, would generally desire a sale of stock rather than an asset acquisition. A sale of stock would avoid a tax at the corporate level in exchange for a capital gains tax at the shareholder level and purchaser's agreement to take a carryover basis in the assets acquired. This assumes that the purchaser would not make a Section 338 election or be deemed to have made such an election under Section 338(e) of the Code. This approach would avoid the payment of tax at the corporate level in exchange for a reduction of tax benefits to the purchasing corporation in future years because of its inability to secure a stepped up basis in the assets for depreciation purposes. Since tax effects are negotiated into the price of the transaction, it may

be said that economically they are borne by both parties in such manner as they agree rather than by the party upon whom the statute imposes the tax. The sellers' capital gain taxes on their stock holdings would by reason of the negotiated price which takes into account the depreciation and investment credit recapture the purchaser must absorb, be similar whether the transaction is a stock sale or an asset sale. Thus, even though an asset sale might be desirable from a nontax economic viewpoint, it would be discouraged under the bill. The bill therefore violates the neutrality principle between stock sales and asset sales.

3. As importantly, what possible justification exists for a tax policy that gives tax preference to 10% or more shareholders, yet denies those benefits to shareholders who own 9.9% or less. The fact that Section 311(d) of the Code adopts that standard in not, in my opinion, sufficient justification. Rather, I believe Section 311(d) represents an anomaly whose change I would support. In essence, I believe that Congress is taking the wrong path. Rather than extrapolate on the 10% shareholders anomaly as the present bill suggests, I would favor elimination of Section 311(d) of the Code provided that General Utilities were not repealed.

4. It is entirely speculative at this point whether the relief provided to closely held corporations will be adequate. I submit that Congress should not enact a bill where the economic impact is not clearly understood.

5. The 5 year ownership rule will impede the flow of corporate capital and create a "lock-in" effect. For example, an individual acquiring a business in corporate form must make a 5 year committment to that business and would be impeded from accepting offers from bona fide outside purchasers during that period. Why should closely held corporations be so shackled? To paraphrase the committee, that clearly would create significant distortions in business behavior. Furthermore, the entire stock structure of the corporation may have to be frozen for 5 years. To the extent that employees or others acquire their stock within 5 years before the time of sale of the business, the General Utilities repeal will apply to impose tax on the transaction. Thus, the principal owner of a closely held business must think twice about permitting employees or others to invest in the corporation.

6. Perhaps the most significant aspect of the repeal of General Utilities and specifically the 5 year "lock-in" rule, would be that the bill would encourage closely held corporations to be conducted in partnership form even where C corporation status would otherwise be desirable for nontax reasons.

Carryover Basis

The second principal reason offered by H.R. 3838 for the repeal of General Utilities for corporate liquidations is that, under normally applicable tax principles, nonrecognition of gain is available only if the transferee takes a carryover basis, thus assuring that a tax will eventually be collected on the appreciation. The commitee report noted at 282 that:

> "Where the General Utilities rule applies, assets generally are permitted to leave corporate solution and to take a stepped-up basis in the hands of the transferee without imposition of a corporate-level tax. [Footnote 28 - The price of this basis step up is, at most, a single, shareholder-level capital gains tax (and perhaps recapture, tax benefit, and other similar amounts). In some cases, moreover, payment of the capital gains tax is deferred because the shareholder's gain is reported under the installment method.] Thus, the effect of the rule is to grant a permanent exemption from the corporate income tax."

I fail to understand the committee's suggestion that the payment of both recapture taxes at the corporate level, and capital gains taxes at the shareholder level is in some fashion an insufficient "price" to pay for the extraction of assets out of corporate solution. In my experience, taxpayers are reluctant to pay both a corporate and shareholder tollgate charge for the right to remove assets from the corporation by way of a complete liquidation.

The effect of the rule as extended by Section 337 is precisely fashioned to ameliorate the hardship of a double tax conclusion in connection with a sale of assets followed by a complete liquidation of a corporation. In commenting on the enactment of Section 337 of the 1954 Code, S. Rep. NO. 797, 95th Cong., 2d Sess. 5-6 (1978) stated, in pertinent part, that:

> "Prior to the enactment of this provision of the Code (sec.337), a sale of property by a corporation which subsequently liquidated generally resulted in two taxes - - one tax on the corporation on the gain realized on the sale, and a second tax on the shareholders on the gain realized by them when they received the proceeds from the corporation in complete liquidation of their stock. Prior to the enactment of section 337, the tax on the sale could generally be avoided only by a distribution of assets to the shareholders in a taxable liquidation followed by a sale under which gain was not realized because the bases of the assets were equal to the sales price. The Congress changed the law in 1954 because these differences accorded undue weight to the formalities of the transaction and they, therefore, represented merely a trap for the unwary.
>
> Congress chose to eliminate the tax at the corporate level."

Absent documented economic evidence clearly linking the elimination of tax afforded by a Section 337 liquidation to a dramatic increase in merger or acquisition activity, I strongly recommend that Congress not seek to substitute its judgment for that of the original drafters of the 1954 Code in fashioning the appropriate form of relief to be accorded a sale of assets followed by a complete liquidation of the corporation.

Accordingly, I respectfully request that Congress not repeal the General Utilities doctrine. Thank you for the opportunity to express my views.

C

CARLETON COLLEGE
ONE NORTH COLLEGE STREET
NORTHFIELD, MINNESOTA 55057-4010

THE PRESIDENT

(507) 663-4308

February 14, 1986

Senate Finance Committee
c/o Betty Scott-Boom
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Chairman Packwood and Members of the Committee:

I write to lend my unqualified support to the position taken before your committee recently by Mr. James G. MacDonald in opposing the provision in H.R. 3838 that would terminate the 65-year-old tax-exempt status of the TIAA-CREF pension system.

As I pointed out in my recent letter to Senator Durenberger, imposing a tax on the TIAA-CREF system, as currently structured, would have the immediate effect of reducing the TIAA retirement income of 150,000 retirees. It would also reduce pension benefits arising from past and future contributions to TIAA for 850,000 faculty participants now accumulating benefits.

The impact on CREF also is likely to be substantial. If CREF is no longer treated as a segregated asset account for tax purposes, it likely would be subject to ordinary corporate taxes on all its pension fund income, resulting in a drastic reduction in CREF's pension benefits. For the past several years, Congress has attempted to provide increased incentives for individuals to provide retirement income for themselves, through IRAs, Keogh plans and the like, in order to reduce the pressure on the Social Security System. The

House bill would move in the opposite direction by greatly weakening a system that has served its one million participants so well for so many years.

It is surely not in the nation's best interests to increase the financial disincentives to become a teacher, especially at a time when ever fewer young people are inclined to go into graduate programs to become college teachers. As I mentioned to Senator Durenberger, low salaries already are a significant disincentive. Further erosion of benefits would only increase the numbers of our brightest, most able graduates who, to the long-term cost of the country, are turning from the teaching profession to business, law and medicine.

As Mr. MacDonald has argued, TIAA retirement annuity contracts contain minimum lifetime income guarantees, which provide a stable, reasonably predictable retirement income. To jeopardize those guarantees by suddenly subjecting the system's contingency reserves to taxation is, in my judgment, unwise public policy.

I strongly urge you to retain the TIAA-CREF tax exemption.

Respectfully yours,

Robert H. Edwards

Robert H. Edwards

RHE:hn
cc: Rudy Boschwitz
David Durenberger
Bill Frenzel
James Oberstar
Timothy Penny
Martin Sabo
Gerry Sikorski
Arlan Stangeland
Bruce Vento
Vin Weber

STATEMENT ON BEHALF OF

CATARACT, INC.
COMMERCIAL OFFICE ENVIRONMENTS, INC.
AND
KIESLING-HESS FINISHING CO., INC.

CONCERNING EMPLOYEE STOCK OWNERSHIP TRUSTS AND SENATE FINANCE CONSIDERATION OF TAX REFORM

by

John B. Huffaker, Philadelphia, PA

February 18, 1986

STATEMENT ON BEHALF OF: CATARACT, INC., COMMERCIAL OFFICE ENVIRONMENTS, INC., AND KIESLING-HESS FINISHING CO., INC. CONCERNING EMPLOYEE STOCK OWNERSHIP TRUSTS AND SENATE FINANCE CONSIDERATION OF TAX REFORM

By John B. Huffaker

My name is John B. Huffaker. I am a member of the firm Pepper, Hamilton & Scheetz, Philadelphia, Pennsylvania. This statement is submitted on behalf of the following corporations and their Employee Stock Ownership Trusts:

1. Cataract, Inc.
   660 Newtown Yardley Road
   Newtown, Pennsylvania 18940

2. Commercial Office Environments, Inc.
   9760 George Palmer Highway
   Lanham, Maryland 20801

3. Kiesling-Hess Finishing Co., Inc.
   300 West Bristol Street
   Philadelphia, Pennsylvania 19140

We want to address two major problems raised by changes in the rules governing ESOTs in H.R. 3838. First, the changes the House bill makes in the qualification provisions are unfair to the employee participants and would disqualify two of the plans I represent as of January 1, 1986. Second, the new diversification rules are too restrictive and do not take into account the practical realities and the nature of stock held in ESOTs. Contrary to the members intent the House bill's diversification requirements would not benefit the participants in ESOT plans.

H.R. 3838 disqualifies plans by limiting to one-third the contributions for persons earning over $50,000.00. While we appreciate the concept of not tilting a plan toward higher paid employees, the solutions in H.R. 3838 require modification to prevent severe, unintended hardships. The plans we represent point up the difficulties with the H.R. 3838 approach.

In one plan we represent well over one third of the of the 500 participants earn over $50,000.00. In another plan there are only about 10 participants because a large number of the employees are covered by another qualified plan under a collective bargaining agreement. Thus, the top three (the ones making over $50,000) receive over one-third of the ESOT contribution in one plan but less than one-third of the total contribution to the Company's qualified plans.

Furthermore, the provisions generally apply to contributions made in the year beginning in 1986. Some ESOTs have obligations incurred in previous years in connection with the purchase of stock that anticipated continuing contributions at or near the maximum level allowed by current law. The provisions of H.R. 3838 would make it impossible to fulfill these obligations which could mean defaults or forced sales to larger corporations. Existing ESOTs should be permitted to function as the retirement plan of employees rather than unfairly and severely punishing employees and companies which have relied on ESOTs under current law as a retirement plan for employees.

One way to avoid the qualification problems of H.R. 3838 would be to apply a relatively simple formula such as doubling the allowance in the event over 10% of the participants would be "highly compensated." Furthermore, any disqualification should apply at the end of the year in which the standard is not met rather than trying to predict exactly what will happen during the course of a year. For example, a plan of a small business could experience a single untimely death which could cause a disqualification. In the Subchapter S area, the Congress designed rules that caused a corporation to have disqualification at the end of the year of the disqualifying event rather than retroactively.

The second issue, we are concerned about is the diversification requirements of H.R. 3838. These are much too onerous. We urge the Committee to consider the following:

1. There should be specific authority to allocate contributions to a plan disproportionately so that a greater amount of cash or equivalent could be allocated to the accounts of the older employees (both before and after an election).

2. When there is a need to diversify but there is no market for the stock, the ESOT's only way to convert stock into cash may be to sell some of the stock to the company. There should be a clear permission for such transactions as installment sales.

3. The statutory pattern must permit a considerable degree of flexibility. While it is possible to plan for retirements, an untimely death or two (or elections to require diversification) can cause unexpected problems in plans of closely held corporations. Thus, the election to require liquidity should be subject to a phase-in period of 5 years or more.

While we appreciate the enormity of the Committee's task in reforming the entire tax code, we urge the Committee to address the concerns of employees and companies participating in ESOTs that have been set up for the benefit of small companies and their employees in reliance on present law. The changes we suggest are revenue neutral. The opportunity to bring these problems to the Committee's attention is greatly appreciated.

Statement for the Record
H.R. 3838

The Cellular Telecommunications Division of Telocator Network of America (Telocator) submits this statement in support of an amendment to the effective date for the investment tax credit and depreciation rates proposed in the Tax Reform Act of 1985, H.R. 3838. Telocator represents cellular companies (a new form of mobiletelephone service) that are classified by the Federal Communications Commission (FCC) as "nonwirelines" -- i.e., cellular companies owned by independent entrepreneurs, in contrast to the competing "wirelines" which are owned by telephone companies. The FCC allocated only enough spectrum for two cellular systems in each market -- one set of frequencies for a wireline system and one set for a nonwireline.

The proposed effective date for the repeal of the investment tax credit and the new depreciation rules grandfathers only equipment under binding contract before September 26, 1985 or placed in service by December 31, 1985. As explained below, unless the nonwirelines receive transition relief, this effective date provision would unfairly place a tax burden on many nonwirelines which, due to FCC policies and procedures, almost all of their wireline competitors will not have to bear.

I. Telocator Proposed Transition Rule

In order to relieve nonwirelines of the tax disadvantage they would otherwise suffer in their competition with wireline telephone companies, Telocator proposes broadening the bill's transition relief to include equipment for any cellular system for which the FCC issued a construction permit prior to September 26, 1985. Because the FCC had issued construction permits only with respect to the 90 largest markets as of September 26, 1985, only they would be eligible for this transition relief. In the remaining 215 markets no construction permits were granted prior to September 26 for either wirelines or nonwirelines. Hence no competitive disadvantages would exist in those markets and no transition relief is necessary.

In the event that the generally applicable effective date for the investment tax credit and depreciation amendments is postponed until January 1, 1987, the transitional inequities that the nonwirelines now face would not occur and there would be no need for a special transition rule.

II. Background

Prior to 1983, there was no cellular industry other than two experimental operations in Chicago and Baltimore/Washington. In 1981 the FCC allocated certain frequencies for cellular use and declared that in each of the 305 metropolitan areas, or markets, in the United States one cellular permit would be awarded to a wireline company and one to a nonwireline company. The purpose of the latter policy decision was to ensure a competitive cellular industry. To qualify as a wireline, an applicant had to be owned by a telephone company operating in the same market. The number of eligible wireline applicants in each market was small and sometimes there was only one. A nonwireline applicant, on the other hand, could be any business entity interested in providing cellular service.

The FCC then considered how to process applications for the wireline and nonwireline construction permits in each market. It established a June 7, 1982, deadline for filing applications for the 30 largest markets, a November 8, 1982, deadline for markets 31 through 60 in size, and a March 8, 1983, deadline for markets 61 through 90. The FCC began by using a comparative hearing process to choose among competing applicants but shifted to a lottery procedure for markets 31 through 90. The very restrictive eligibility requirements for wireline applicants and the wide-open eligibility requirements for nonwirelines caused the delay for the nonwirelines which in turn led to the tax inequity at issue here.

III. The Need for Telocator's Proposed Transition Rule

In the top-90 cellular markets, 75 wirelines had completed construction and received their operational licenses before September 26, 1985. As a result, their equipment purchases are not affected by the proposed tax legislation and are eligible for the more advantageous tax benefits that the bill would eliminate. However, only 17 nonwirelines had completed construction and had licenses by September 26, 1985. Therefore, most nonwirelines would not qualify for the tax benefits available to the wirelines and would be placed at a substantial disadvantage in head-on competition with wirelines in their markets if they are not granted transition relief.

The headstart of the wirelines over the nonwirelines is directly attributable to FCC policies. In the top-30 markets wireline applicants avoided the comparative hearing process altogether because there was only one per market or because they were sufficiently limited in number to be able to settle quickly. The larger number of nonwireline applicants in each market made settlement far more difficult. As a result, none of the wireline applications in the top-30 markets went to a comparative hearing but almost all of the nonwirelines were designated for hearing. Thus, although both wirelines and nonwirelines filed their applications in the top-30 markets at the same time, the nonwirelines did not receive their construction permits until an average of 12 months after the wirelines received their permits.

By way of example, in the Atlanta market where five nonwireline applications were filed on June 7, 1982, the applications were designated for hearing on January 21, 1983; the record was closed on December 2, 1983; the Administrative Law Judge issued the initial decision on February 27, 1984; the FCC approved the decision and granted the construction permit on January 29, 1985; an appeal was filed in the federal Court of Appeals on February 27, 1985; oral argument took place on February 14, 1986, and no decision has yet been rendered. By comparison, the wireline received its construction permit on January 21, 1983 and the system went on line in July, 1984.

The FCC switched to a lottery selection process for markets 31 through 60 and 61 through 90, though it did so substantially after applications for these markets had been filed. Cellular Lottery Rulemaking, 98 F.C.C. 2d 175 (1984). Under this new procedure, the nonwirelines still suffered a disadvantage. In almost all cases market-wide settlements were negotiated and agreed to. But these settlements took much longer to arrange among nonwirelines because of their far larger numbers. Thus, in markets 31 through 60, most markets had 12 or more competing nonwireline applicants, and in markets 61 through 90, there was an average of 16 nonwireline applicants. The average number of applicants for wirelines in markets 30 through 90, by contrast, was still a very manageable 2.6 per market.

Because of the far larger number of nonwireline applicants in markets 31 through 90, their settlements took much longer than the wireline settlement process. Thus, the settling nonwireline applicants each had to agree first to take a pro rata interest in the company that would operate in the market in question. Then they swapped interests in the various markets to achieve some measure of consolidation and business rationality. This process was not substantially completed until long after nearly all of the wirelines had reached settlement. For example, in the Salt Lake City market, the wireline received its construction permit on April 26, 1984, and was operational by December, 1984. But the nonwireline did not even receive its construction permit until March, 1985, which was when many other nonwirelines in the 31 through 90 markets received their permits. Compared to the September 26, 1985, date in the House tax bill, the Salt Lake City wireline had 17 months and the nonwireline had only six months to order equipment. Because the process of ordering equipment and launching a cellular system takes a considerable amount of time, the much smaller amount of time left to nonwirelines to complete this process by the deadline established in the House tax bill was simply inadequate in many cases.

Moreover, the various steps to be undertaken before central switches and other equipment could be ordered were made more complicated by the fact that the settlement process resulted in nonwireline permits being held by partnerships with large numbers of partners. In most nonwireline markets, therefore, partnership committees reviewed and authorized the following decisions leading up to orders for appropriate equipment. They had to review the design of the systems which engineers and others had agreed to on the basis of a careful review of the various applications in the market. They had to evaluate and then choose among a changing and sophisticated selection of computer based switching and other equipment in light of their systems' needs. There were numerous difficulties with respect to selecting the location of various towers needed for the operation of the systems and with respect to obtaining zoning approvals for them. The resolution of these difficulties could affect their equipment selection. Consequently, it is entirely understandable that many nonwirelines were unable to order equipment before September 26, 1985 or place it in service by December 31, 1985.

If transition relief is not made available, nonwireline systems that have been delayed by the FCC's processes would be placed at a substantial competitive disadvantage. For example, if a cellular system in a particular market costs $10 million to construct, the wireline would have had the substantial benefit of a $1 million investment tax credit while its nonwireline competitor would have no credit, and for several years the wireline would receive more rapid depreciation than its nonwireline competitor. These discrepancies would enable wirelines to charge lower rates and otherwise have an unfair and undeserved competitive advantage over nonwirelines.

Based on Telocator's survey of a substantial number of nonwireline systems, it believes that the impact on tax revenues of the proposed transition relief, including both investment tax credit and depreciation, would be in the neighborhood of $15 million. Although the effect on tax revenues would be relatively small, the relief would be very significant to the emerging nonwireline industry. It already operates under the handicap of starting later than the wireline industry; the wireline systems are owned in large part by powerful regional telephone companies with cellular interests that span whole regions of the country; and the nonwirelines incurred far greater hearing and settlement expenses to obtain their FCC permits than did the wirelines. With nonwirelines being the only source of competition to wirelines in the duopolistic cellular market, the FCC and the District Court have recognized the special importance of nonwirelines developing into full competitors of the wirelines. Thus, the requested relief is desirable not only as a matter of tax equity but also to promote the public policy goal of a competitive cellular marketplace.

IV. Relationship of Telocator's Transition Rule to Other Transition Rules

Telocator's proposed transition rule is not unique. A similar transition problem was encountered and remedied by the drafters of H.R. 3838. Section 203(d)(2) of the bill grants transition relief to certain projects if, on or before September 25, 1985, the Federal Energy Regulatory Commission ("FERC") had licensed the project or certified it as a "qualifying facility" for purposes of the Public Utility Regulatory Policies Act of 1978. In both cases, substantial time and money had been expended in the regulatory process prior to September 26, 1985. In both cases, the necessary regulatory analysis and review entailed significant delay not faced by other taxpayers who made their investment decisions without such extensive federal regulatory review. And in both cases, the initial decisions to pursue the projects were made long before September 26, 1985, in anticipation of the continued availability of the investment tax credit. The case for the nonwirelines is even stronger since relief is needed to provide them with equitable tax treatment vis-a-vis their wireline competitors.

That special transition relief is appropriate for certain taxpayers subject to federal regulatory action is also demonstrated by the transition rules enacted when the investment tax credit was terminated under Section 703 of the Tax Reform Act of 1969. Sections 703(b)(3)(C) and (b)(6)(B) of that Act provide that, in defined circumstances, property described in certificates or orders issued by a federal regulatory agency before termination of the credit would be treated as "pretermination property" (and thus still eligible for the investment credit) even though not satisfying the general definitional requirements. These provisions show a history of Congressional solicitude for taxpayers who, although clearly committed to acquiring or constructing property prior to a statutory deadline, are unable to begin construction or enter into binding contracts in the ordinary course of their businesses as a consequence of the regulatory process.

V. Conclusion

Transition relief for nonwirelines is essential to prevent the creation of a significant tax inequity. Wirelines and nonwirelines constitute two classes of taxpayers that are similarly situated, but FCC procedures have caused one -- the wirelines -- to be eligible for substantially more advantageous tax treatment than the other -- the nonwirelines. That inequity will inhibit the full and fair competition crucial to a competitive industry. Appropriate transition relief would be consistent with similar remedies in the past, would be limited in scope to only those cellular systems authorized prior to September 26, 1985, would involve only a small revenue loss and would rectify an otherwise wholly unjustified discrepancy in the tax treatment accorded to competitive cellular systems in the top-90 markets.

The text of a proposed amendment to the bill is attached as Appendix A.

Appendix A

AMENDMENT to SECTION 203(d):

(14) Certain Cellular Systems -- In the case of property which is part of a system in the Domestic Public Cellular Radio Telecommunications Service covered by an FCC construction permit issued on or before September 25, 1985, such property shall be treated as satisfying the requirements of paragraph (b)(1) of this section.

CHEMICAL MANUFACTURERS ASSOCIATION
STATEMENT ON TAX REFORM

The Chemical Manufacturers Association (CMA) is a nonprofit trade association whose member companies represent more than 90 percent of the productive capacity of basic industrial chemicals within this country. We welcome this opportunity to submit the views of the U.S. chemical industry on tax reform and in particular the impact the President's 1985 Tax Reform Proposal and H.R. 3838 would have on the chemical industry.

CMA supports President Reagan's stated goals of economic growth, fairness and simplicity, but the current proposals fail to meet any of those goals. In an attempt to achieve revenue neutrality, the proposals unfairly shift a substantial portion of the income tax burden now borne by individuals and noncapital intensive corporations to America's capital intensive industries. This shift would cause a reversal of recent economic growth and a reduction in America's international competitiveness, with further increases in an already massive trade deficit. Moreover, the complexities inherent in both proposals would totally undermine the goal of simplicity and would increase significantly the administrative burdens of tax compliance. Similar to the consequences of any increase in Superfund feedstock taxes or the imposition of an oil import fee or other energy tax, the increased costs that would result to the chemical industry from these tax reform proposals would have a damaging impact on the domestic and international competitive position of the chemical industry.

ECONOMIC GROWTH

Both tax reform proposals would do significant damage to the economy, particularly the capital intensive industries, of which the chemical industry is a prime example. This industry spends more than $15 billion annually on plant, equipment, and machinery. It directly employs more than 1 million Americans, and indirectly provides jobs for countless others.

Both proposals remove important incentives for capital investment by repealing the ten percent investment tax credit and reducing deductions for capital cost recovery (depreciation). Unfortunately, these two provisions play a major role in keeping the program revenue neutral. In other words, tax reform would be paid for by capital intensive industries. Treasury revenues overall would theoretically be equal, but the President's proposal shifts a tax burden of nearly $122 billion from individuals to corporations over the next five years. The House bill increases this amount to nearly $140 billion. By comparison, the proposals would increase taxes for capital intensive and growth businesses by $160-$260 billion over the same period. Thus, the cost to industry of the reduction in capital incentives exceeds the total shift of tax burden to corporations. CMA believes that this shift is too large, too sudden, and too burdensome on a narrow sector to be healthy for the economy.

CMA and many prominent economists have concluded that the massive tax increase on capital intensive business contained in these plans would cause a significant increase in the cost of capital, with a resulting slowdown in capital investment, an increase in the overall cost of U.S. manufactured goods, a decline in international competitiveness, and an increase in our trade deficit. This is especially true for the chemical industry.

Experience with the investment tax credit, which was introduced in the early 1960s and has been suspended twice, supports these pessimistic views. An analysis by the American Council for Capital Formation found a direct correlation between the tax credit and jobs. When the credit is available, the ratio of jobs to population increases. When the credit is increased, the ratio grows faster. When the credit is removed, the ratio declines and unemployment increases.

Coupling the repeal of the investment tax credit to the adverse changes in depreciation only exacerbates the effect on unemployment. On a macro-economic basis, we estimate that for every $1 billion loss in investment there is a corresponding loss of 50,000 jobs throughout the economy. A recent study by the Harvard University's Center for Business and Government predicts that the President's proposal to repeal ACRS and the investment tax credit could reduce capital spending by $30 billion, translating into a loss of 1.5 million jobs throughout the economy (a 1.28 percent increase in total unemployment). The depreciation changes contained in the House bill do not improve this result.

CMA recently requested the Institute for Research on the Economics of Taxation (IRET) to prepare a study of the impact on the chemical industry of the President's tax proposal and the options then under consideration by the House Ways and Means Committee (the capital cost recovery provisions of H.R. 3838 are not significantly different from the Committee options analyzed in the IRET Study). The IRET Study is attached.

The IRET Study concluded that the reform proposals regarding capital cost recovery, the alternative minimum tax proposals, and the excess depreciation recapture provision in the President's proposal, would have:

> devasting effects on the U.S. chemical manufacturing industry. . . . Despite the proposed reductions in statutory tax rates, these changes would raise the effective tax rates to which chemical manufacturing companies are exposed and would, as a result, materially slow the growth in the industry's production facilities and employment, cost the industry's employees billions of dollars in lost real wages, and reduce the industry's output substantially below levels that would otherwise prevail. The competitive position of U.S. chemical manufacturers in both domestic and foreign markets would be significantly eroded.

The study estimated the effects as follows:

	President's Proposal	Ways & Means Options Proposal
	($ in billions)	
Loss of Real Wages 10 Year Total	$ 4.4 - 5.5	$10.5 - 13.0
Loss of real output 10 Year Totals	$ 8.5 - 10.7	$20.3 - 25.2
Reduction in Investment (versus current law)	$10.5 - 13.2	$24.8 - 30.6
Percentage Increase in Cost of Capital for Machinery	4.4%	10.9%
Percentage Reduction in Present Value of Capital Cost Recovery Alowance for Machinery	13.5%	24.9%

These numbers reflect only the direct effects on the chemical manufacturing industry. Indirect effects were not explicitly estimated. IRET concluded that the indirect effects of these proposals might well be equal to the direct effects.

CMA further estimates that the repeal of ITC and ACRS alone would reduce cash flow available to the chemical industry by over $1.6 billion per year. Clearly, the results summarized above for the chemical industry hardly can be seen as a formula for promoting growth.

The IRET study reached the following conclusion regarding the impact of the proposals on international competitiveness:

> The contraction of chemical manufacturing production capacity, employment, and output, relative to present law, that would result from the proposed tax changes would obviously weaken the position of U.S. chemical manufacturers in both the domestic U.S. market and foreign markets. The increase in the cost of capital and in effective tax rates that would result with the proposed tax changes would significantly erode the profitability of the U.S. industry. Given the nature of the industry's output and the conditions of demand prevailing in both domestic and foreign markets, there would be little if any opportunity for chemical manufacturing firms to restore profitability through price adjustments. The expected result is that a larger share of the domestic U.S. demand for chemicals would be met by foreign producers, while U.S. producers would account for a smaller fraction of chemical product sales in foreign markets.

The U.S. trade deficit is one of the United States' most serious economic problems. Even the electronic and computer industries contributed to the trade deficit in 1985. Among other problems, U.S. manufacturers are still trying to get out from under the weight of the strong dollar and win back the market share captured by weak-currency imports. The chemical industry has been one of the few bright spots, but even its trade surplus has declined almost 25 percent in the past four years from $10 billion in 1982 to $7.6 billion in 1985. Worldwide competition is fierce. Now is not the time to place additional handicaps on the manufacturing sector by increasing the cost of U.S. production.

In summary, the current tax proposals would create a new but shortsighted industrial policy for the United States. The proposed policy is biased against the manufacturing sector and would in fact promote the deindustrialization of America.

In addition, the decline of the nation's manufacturing base would inevitably result in a loss in the high tech and service industries. If capital spending in manufacturing were further restricted by tax disadvantages, not only would U.S. manufacturers be unable to modernize, increase productivity, and remain competitive in the worldwide marketplace, but U.S. service industries supporting domestic manufacturers would likewise suffer from economic contraction. The result would be a shift of capital investment outside the United States to the detriment of all U.S. economic sectors. Accordingly, we strongly urge that any change in the tax treatment of capital investment should result in no greater cost of capital than under present law.

FAIRNESS

All too often, the burden of increased corporate taxes ultimately falls on the one group that can least afford it -- the factory workers who are handed layoff notices. One only has to look at the loss of two million jobs in the manufacturing sector and 50,000 in the chemical industry over the last 10 years to see who really bears the burden of having non-competitive costs imposed by government policies. A tax policy that can only exacerbate this situation can hardly be viewed as "fair."

In discussing tax fairness, CMA is compelled to address the frequently publicized misconception that the chemical industry enjoys a low effective tax rate. The Pease-

Dorgan effective tax rate study has been cited to suggest that corporations in the chemical industry are not paying their fair share of taxes under current law. That impression is false and certainly should not be the basis for major changes in tax policy.

CMA commissioned Price Waterhouse to do an expanded study on chemical industry effective tax rates. Price Waterhouse examined the record of the 15 largest corporations classified by the Securities and Exchange Commission as having their primary business in the industrial chemical category. Using the Pease-Dorgan methodology, these 15 companies had an effective tax rate on U.S. income of 23 percent in 1983 and nearly 31 percent in 1984. The comparable figure for all industries was less than 17 percent in 1983 (1984 figures are not yet available). In other words, the chemical industry is faced with a substantial increase in its tax burden when it is already taxed at an above-average level.

Much has been made of the concept of a "level playing field" among investments in promoting tax fairness. It is important to note, however, that our tax system is already biased against capital spending. Those of us in capital-intensive businesses feel that an ideal tax system would treat the costs of capital and labor the same; i.e., as current expenses. Repealing the ITC and slowing depreciation deductions would not level the playing field as some claim, but would further tilt it to the disadvantage of capital intensive industries.

Finally, as a matter of fundamental fairness, tax reform should not be permitted to have any retroactive effect. For example, the legislation should not change the tax treatment of deductions relating to, or income flowing from, investments in plant and equipment which have already been made, or committed to, in reliance on existing law. Similarly, the proposed changes in the LIFO inventory method should not have any retroactive effects.

SIMPLICITY

The third goal, simplicity, can be dealt with briefly. Present law, although complex, is far simpler for corporations than either of the current proposals. We need only look at the constant changes in the depreciation rules, the third major change in five years, or an alternative minimum tax that requires an entirely new and separate set of tax records. To these we can add the proposed changes in inventory accounting and the foreign tax provisions, which are so complex as to be almost beyond comprehension. In fact, we have serious concerns about whether companies will be able to comply with many of the new foreign tax proposals at all. Staggering modifications to taxpayers' computer systems and capacities would be required to comply with these changes.

ADDITIONAL SPECIFIC CONCERNS

Following is a summary of CMA's additional specific concerns about the President's proposal and the House Bill.

A. Foreign Tax Credit (FTC) Limitation

CMA opposes the proposed changes to the existing overall method of determining the foreign tax credit limitation. The President's proposal, after acknowledging that the objective of the FTC is to avoid double taxation of foreign income, states that limiting the credit to the United States tax on foreign income on a country-by-country basis, rather than on an overall basis, is more consistent with this goal and would lead to more rational incentives for investments. In other words, foreign income taxes of a particular country would be creditable only to the extent of the United States income tax allocable to the income from that country. Moreover, the ordinary U.S. rule of sourcing dividend income at the place of incorporation of the payor would be modified in calculating the indirect credit. Dividends from subsidiaries earning income in more than one country would generally be required to be re-sourced. Similarly, foreign income taxes would generally be traced to the country to which they are paid.

H.R. 3838 adopts an approach which, although it retains in principle the overall limitation, sets up separate limitation categories for certain types of income. In order to prevent high foreign taxes on a particular category of income from offsetting United States tax on low taxed income, the following separate baskets are established in addition to the overall limitation for trade or business income: passive income, banking or insurance income, and shipping income. Passive income would include dividends, interest, annuities, rents, certain royalties, and gains from the sale of property giving rise to such income.

CMA believes that the current provisions respecting the foreign tax credit are most satisfactory and there is no compelling need to make such basic revisions. Both the President's proposal and the House bill would add enormous complexity to already complex provisions.

Moreover, CMA disagrees with the view expressed in the President's proposal that the overseas investment decisions of multinational companies are made for purely tax motivated reasons. The decision to operate abroad requires the evaluation of many factors, of which foreign taxation is but one. The economy of the country of investment, the stability of its government, ease of access, quality of the labor market, climate and environment, and receptivity of the country's people to the proposed enterprise are all important factors in foreign investment decisions. Business does not pursue lower taxes in disregard of all other factors. In fact, the Department of Commerce data for 1982 showed that the overwhelming bulk of all manufacturing investment takes place in foreign "high-tax" rather than "low-tax" countries.

Nevertheless, if United States industry is to be competitive with industries of other countries, it must be given the opportunity to take advantage of tax regimes in all countries (as do its competitors). As to nonmanufacturing investment, it is submitted that the 1984 amendments to the Code preclude any further unwarranted manipulation by taxpayers.

It is our firm belief that the United States policy of taxing worldwide income requires that the United States adopt rules which clearly eliminate international double taxation of foreign income. It is only fair and equitable to allow a credit on an overall basis. There is no fundamental merit in excessive fragmentation of the limitation of the foreign tax credit at the expense of United States industry. This expense consists of the obligation to pay incremental U.S. taxes on foreign source income even where the effective overall foreign tax rate on such foreign source income equals or exceeds the U.S. tax rate.

If the provisions of H.R. 3838 are favorably considered it is suggested that the following modifications be made: 1) the current exception to separate limitation treatment for business related interest income should be retained and made applicable to passive income earned by 10 percent-owned foreign corporations; 2) a "de minimis" rule should permit 10 percent-owned foreign corporations to earn small amounts of interest income without triggering the separate limitation for the U.S.

shareholders; 3) separate limitation treatment should not apply where a foreign jurisdiction's statutory tax rate is 36 percent or higher. The proposal's requirement for a 36 percent effective tax rate ignores the effects of net operating losses and differences between U.S. and foreign tax accounting practices for local tax payments.

B. Source of Income Rule for Sales

CMA opposes the change H.R. 3838 makes to the existing rule relating to the source of income derived from the sale of property. This proposed change would apply to (1) the purchase and resale of property and (2) the manufacture and sale of property. Its adoption would have many ramifications throughout our federal income tax system. This change, in principle, adopts the President's proposal.

Under present law, income from the purchase and sale of tangible and intangible personal property is considered derived from the place where the title (and risk of loss) to the property passes. This essentially practical and objective principle stemmed from a long line of cases and, in 1957, it was made a part of the Treasury regulations at §1.861-7. For tax avoidance transactions, however, the existing regulation allows an analysis of the substance of the elements of the transaction. The title passage principle also has been incorporated in the Treasury regulations used in determining the portion of the income attributable to the sales factor for the purpose of allocating gain from the sale abroad of U.S.

manufactured goods. See example (2) in Treasury regulation § 1.863-3(b)(2).

The explanations of the President's proposal and the House bill assert that the "title passage" test bears no necessary economic relationship to the economic activity generating the income from the sale. The proposed solution is a new rule, which provides that income from the purchase and resale of inventory-type property would be sourced in the country of the taxpayer's residence. An exception would be made in cases where the taxpayer had a foreign fixed place of business that participated materially in the selling activity generating the income outside the United States. However, this exception would not be available for sales to affiliates. In general, under the proposal, the place where the title passes, where the purchase is made, and the place of destination all would be irrelevant. Similar rules would apply to income from the manufacture and sale of products.

Thus, a domestic corporation would always be treated as a United States resident, and its foreign sales income would always be U.S. source, unless an exception to the general rule applied. Thus, agreements which were entirely negotiated, executed and implemented abroad could still result in U.S. source income for a U.S. corporation with little or no commercial operations within the U.S.

The chemical industry believes it is highly undesirable to change the present long-established title passage rule, which provides certainty, for one which is ambiguous and imprecise and would require years of prolonged litigation to clarify. When specific problems arise, they can be addressed on a case-by-case basis, as was extensively done in the Deficit Reduction Act of 1984.

If the proposed source rule for sales were adopted, we would recommend that the "material participation" exception not be limited to sales to unrelated parties. Denying this exception in the case of all sales to affiliates unduly penalizes exporters -- especially large exporters -- which need to rely on foreign sales affiliates to coordinate overseas marketing.

C. Allocation of Interest Expense

CMA opposes the provision of H.R. 3838 that requires the interest expense of each member of a domestic affiliated group to be allocated to other members of the group using an allocation method that treats the group like a single corporation. This provision follows the President's proposal. The new rules would apply to all members of an affiliated group eligible to file a consolidated return, whether or not there is an election to file such a return. These provisions would conclusively deem that money borrowed by one member of a consolidated group operating in the U.S. was in part borrowed by another member of the group operating abroad, even if the borrowing company in fact borrowed to make a U.S. investment and the affiliate operating abroad had no need to borrow.

Moreover, these rules would apply to the allocation of other types of expenses, to the extent they are not specifically excluded.

The four major changes in H.R. 3838 for allocating interest expense are as follows: 1) U.S. parent companies and all of their 80-percent or more owned domestic subsidiaries would be required to allocate their interest expense under the consolidated asset method; 2) the optional gross income method for allocating interest expense would be repealed; 3) the asset basis for investments in foreign subsidiaries would include a proportionate share of the undistributed earnings and profits of such foreign subsidiaries; and 4) intercompany interest income and expense between U.S. members of the group would be eliminated for U.S. income tax purposes.

The proposed changes are illogical, ignore the real world of corporate finance, are contrary to tax practice that has been carefully considered for 20 years, and would make U.S. multinational companies less competitive in making U.S. investments.

D. Allocation of R & D Expenses

CMA reiterates its position that the statutory moratorium on the required allocation of research and experimentation expenses under Treasury Regulations §1.861-8 should be made permanent. The reform proposals fail to do this. On November 3, 1983, CMA presented extended testimony in strong support of this policy before the Subcommittee on Oversight of this Committee. For the reasons stated there, it is our continued belief that failure to extend or to make permanent this statutory moratorium would be an added reason for locating new research facilities and operations outside the United States with the loss of both new U.S. jobs and technology.

E. R&D Credit

CMA believes the R&D credit should be made permanent at the current 25 percent rate. The President's proposal urged a three-year extension of the existing 25 percent tax credit for incremental research and development, with a tightening of the definition of eligible expenditures. H.R. 3838 adopts the three-year extension, but reduces the rate to a 20 percent.

The chemical industry believes that the credit has contributed significantly to the continuation and expansion of research programs in general (cf. the recently published study "The Need for a Permanent Tax Credit for Industrial Research and Development," by H. N. Bailey and R. Z. Lawrence of the Brookings Institution and by Data Resources Inc.), and to the health and prosperity of the United States chemical industry in particular. The chemical industry has a vital interest in the continuing search for ideas which will contribute to future expansion in productive capacity in the United States and the development of new job opportunities. The industry is in the forefront of research oriented activities.

As a nation, we need a strong private sector research establishment. New technology is the source of continued economic growth and carries the basis for jobs in the future. It is imperative that U.S. policy encourage domestic research activity. In addition, research programs require long lead times, and the uncertainty regarding the future that will result from a mere three-year extension will be detrimental.

F. 80/20 Corporations

CMA opposes the elimination of the 80/20 rule. Historically, interest and dividends paid by a domestic corporation constitute U.S. source income. However, as far back as the 1920's, such payments were treated as foreign source income if the domestic corporation derived less than 20% of its gross income for a prior period from sources within the United States. (The 80/20 rule). H.R. 3838 repeals this exception, and all such dividend and interest payments would be considered U.S. source income.

The adoption of the 80/20 rule and its continued re-enactment for the past 60 years were based on the sensible policy that dividends and interest paid out of gross income which is substantially foreign income should themselves be foreign source. The proposed elimination is basically inconsistent with the principles adopted in many provisions of the Revenue Act of 1984, which focused on the source of the underlying income for determining the source of distributions and interest.

G. Corporate Minimum Tax

CMA opposes any expansion of the corporate minimum tax. Both the President's proposed reform package and the House bill contain damaging proposals to substitute an "alternative" minimum tax for the "add-on" minimum tax currently applicable to corporations. In addition, numerous proposals of a similar nature have recently been offered by others.

The alternative minimum tax proposals would create a dual tax system the effect of which would be to undermine important provisions contained in the income tax laws, place the heaviest burden on those companies least able to afford the tax, and further complicate corporate recordkeeping and tax compliance.

As an alternative to the regular tax, the alternative minimum tax would be calculated at a different rate (President's proposal-20%, H.R. 3838-25%) on a broadened base determined by increasing regular taxable income by certain "preference" items.

New or broadened tax preference items of particular interest to the chemical industry contained in the President's and/or H.R. 3838 proposal include all or parts of the following items:

1. The accelerated or incentive element of depreciation on real and personal property.

2. Excludable income of Foreign Sales Corporations.
3. Deferral benefits of the completed contract method of accounting.
4. Deductions for mining exploration and development costs in excess of an amortization allowance for such costs.
5. Deductions for intangible drilling and development expenses incurred in connection with oil and gas wells.

For this industry, the alternative minimum tax is in the nature of a permanent flat tax at a very high rate. The creation of a dual tax system based on broadened concepts of tax preferences is inappropriate, particularly while consideration of comprehensive tax reform is pending. Items that are in fact unsound or ineffective should be dealt with in the context of reform, rather than in a revised minimum tax. The so-called preferences represent Congress' well-considered tax policy decisions, typically designed to spur economic growth or strengthen particular industries by eliminating the bias against savings and investment. For example, the Foreign Sales Corporation rules were first adopted in 1984 to replace DISC and promote U.S. exports. Classification of such items as taxable preferences undermines sound tax policy.

Moreover, an alternative minimum tax of the type proposed falls most heavily on companies that can least afford it. Its greatest impact is on companies with low regular tax liability, which may be attributable to depressed earnings or substantial investments in expanding or growing businesses. In fact, our projections indicate that a chemical company that is continuing to invest and grow would be subject to the minimum tax on an ongoing basis unless it had another income source base not generated by a capital intensive business.

H. Cost Accounting For Inventories and Taxpayer-Constructed Assets

Both the President's proposal and H.R. 3838 would impose new, stricter rules for capitalizing certain overhead costs as a cost of producing inventory or as a cost of constructing taxpayer-built property. These "super" full absorption rules would apply to manufacturing companies in all industries, regardless of their financial accounting practices. The costs to be capitalized include, among others, (1) tax depreciation in excess of depreciation reported on financial statements, and (2) certain research and product development costs (President's proposal only). It is obvious that taxpayers would no doubt be forced to make two complex computations (rather than just one) of their inventory and self-constructed property costs.

All taxpayers would have to recompute opening inventories using the new rules, taking into taxable income over a five-year period the resulting differences between old and new opening inventory values. Thus, the legislation is retroactive for all taxpayers.

The recomputation of beginning inventories is especially unfair and burdensome for those taxpayers who are on LIFO. These taxpayers probably cannot make an accurate calculation of the effect of this change in accounting with respect to their opening inventories since they would have to refigure inventories for all years that they have been on LIFO. They would therefore be forced to use the highly inaccurate estimate set forth in the House bill to revalue their inventories.

I. Transfers of Technology to Foreign Subsidiaries

CMA opposes section 641(e) of H.R. 3838, which substantially amends (and distorts) the well entrenched and understood international legal principles of §482 dealing with arm's-length pricing of, or cost-sharing arrangements for, transfers (including licenses and other arrangements for use) of intangibles abroad.

The bill would substitute for the existing arm's-length standard in both §482 and §367(d) a requirement that payments for transfers to controlled foreign corporations be "commensurate with the income attributable to the intangible," and be redetermined periodically.

This proposal is at variance with the long-established principle that dealings between related parties should be accomplished on the same basis as those between unrelated parties. The United States has been instrumental, through the OECD and otherwise, in persuading the international community to adopt this rule. We should not repudiate it unilaterally. The likely refusal of other countries to follow the new standard will result in double taxation and the breakdown of Competent Authority procedures under existing treaties.

The proposed standard is also so amorphous that it would be virtually impossible to attain any certainty in its application without years of extensive litigation. The existing rules and regulations, by contrast, are adequate to deal with the concerns expressed in the House report. Moreover, if U.S. corporate taxpayers were to license third parties to use the same or similar technology, the controlled licensee/grantee would then be at a competitive disadvantage. This disadvantage would be compounded if it were more efficient and cost effective than its foreign competition.

J. Section 936

CMA supports the retention of the §936 credit. The President's proposal would have replaced the credit with a credit based on wages. H.R. 3838 rejected this proposal. Instead it would (1) increase the cost sharing payment under the cost sharing option to 110 percent of present law, or if greater, the royalty payment under revised section 482 and 367, (2) for companies which elect the 50/50 profit split, the amount of product area research expenditures would be increased by 20 percent for computing combined taxable income, and (3) the active business income test is raised ultimately to 75 percent.

CMA believes that, in order to attract and maintain quality manufacturing operations in the U.S. possessions, tax incentives more substantial than those contained in the President's proposal are essential. These tax incentives have worked. The quality of employment in Puerto Rico has improved because of the present program, resulting in an increasing skillful workforce. The President's proposal would result in a dramatic increase in unemployment.

Insofar as the changes recommended in H.R. 3838 are concerned, CMA believes it would be preferable to make no changes in present law. In particular, no change should be made in the present application of the standards contained in § 367(d) and § 482.

CONCLUSION

In conclusion, CMA believes the United States needs a tax policy that creates jobs by encouraging capital formation and improving the competitive standing of U.S. companies in world markets. The way to do that is to provide incentives for savings and investment, broaden the tax base, and avoid shifting massive tax burdens between individuals and corporations. The capital formation and foreign provisions of current law should be retained, the alternative minimum tax should be rejected, and incentives for research and development should be made permanent.

February 24, 1986

STATEMENT OF THE CHICAGO BAR ASSOCIATION
COMMITTEE ON FEDERAL TAXATION
CONCERNING
TREATMENT OF NET OPERATING LOSS
AND
OTHER TAX ATTRIBUTE CARRYOVERS
FOLLOWING CORPORATE ACQUISITIONS

Sections 382 and 383 of the Internal Revenue Code of 1954[1] will be substantially amended by the Tax Reform Act of 1976 at midnight December 31, 1985, unless the effective period of the existing provisions is extended for a fifth time or new provisions are enacted. These sections treat and impose limitations on the applicability of net operating loss, capital loss and various credit carryover attributes (all herein referred to as "tax carryovers") after significant ownership or business changes affecting the loss corporation. There is official dissatisfaction with the gaps in the existing provisions and widespread concern over the complexity to be imposed by the 1976 Act.

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1) All section references herein are to the Internal Revenue Code of 1954 unless otherwise indicated.

As part of a complete revision of Subchapter C of the Internal Revenue Code dealing with the income tax treatment of corporations and shareholders, the Senate Finance Committee Staff in May 1985 presented a new approach to the tax carryover problem area (the "SFC Proposal") partially based upon or reminiscent of the 1958 Advisory Group Report on Subchapter C, the Bacon & Tomosulo proposal set forth in 20 Tax Notes 836 (1983) and the American Bar Association Section of Taxation Proposal, dated February 6, 1985 (the "ABA Proposal"). Assistant Treasury Secretary for Tax Policy Ronald Pearlman responded favorably to the SFC Proposal with certain recommendations for changes of a more or less technical nature (reported in the BNA Daily Tax Report, No. 190, pp. J-10-21, 10/1/85). The House Ways and Means Committee as part of a general press release (reported in BNA Daily Tax Report No 209, pp.G-5, 6, 10/29/85) announced that its proposal would follow along the same general line but with some further changes in detail.

The basic structure of the new approach is to impose an annual limitation on the use of tax carryovers after a triggering event consisting of the change of ownership of a loss corporation, such limitation to be determined by applying a percentage rate to the value of the loss corporation at the time of the change. The basic appeal of the approach is its conceptual simplicity. It applies one limitation rule, triggered by one type of event (ownership change), whether effected by taxable stock purchase transactions or by non-taxable reorganization transactions.

Because of the urgency and importance of the matter and the shortness of the period for decision, the Chicago Bar Association Committee on Federal Taxation wishes to present its views to responsible persons involved in the legislative process as an expression of opinion and preference by a group of practitioners with long experience and deep interest in the area. It does not pretend to have superior wisdom, but it believes it represents a fairly representative group of practitioners interested in protecting the public fisc in accordance with clear, easily understood rules of relative simplicity, while at the same time allowing business to be transacted without undue attention to tax considerations. It states at the outset that it accepts the SFC Proposal approach and does not favor free trafficking in tax attributes, but would trim and narrow the Proposal in certain respects in the interests of simplicity and better reflecting the realities of the business environment. Further, it favors regarding the revised Sections 382 and 383 as part of a spectrum of overall regulation and limitation and not as the exclusive and total means of preventing abusive trading in tax attributes. Once Sections 382 and 383 are viewed as complementary rather than absolute measures of limitation, they can and should be kept relatively simple and broadly comprehensible. This is particularly appropriate now that Sections 382 and 383 are being considered more or less alone and not as part of a sweeping revision of entire Subchapter C.

General Approach and Rate of Absorption.

The SFC Proposal embraces the so-called "neutrality principle" of limiting tax carryovers. It aims at preventing the successor of a loss corporation from realizing benefits from the carryovers more than those likely to be realized by the loss corporation itself, while at the same time not impeding the successor's ability to derive the equivalent of such benefits. The neutrality principle also encompasses the idea that tax carryovers themselves are not to be significant objects of commerce, that is, mere shells without value apart from tax carryovers are not to be desirable targets for acquisition. It is in this latter respect that the principle makes more sense.

The first meaning of the principle--successor to fare no better than the loss corporation--has an enormous threshold gap in meaning so that without further explanation it appears at first blush to be a conceptual self-contradiction. A loss corporation gets no value from its carryovers unless it turns around and makes a profit. Literally, there is no way that the loser's experience can constitute a guide for a profitable successor. Unless, of course, the principle is expanded to embrace some reasonable, broadly acceptable model dealing with the nature and extent of the loser's conversion to profitability. So far, the proposals on the table refer to two widely differing models with some minor variants in between.

The SFC Proposal model of tax carryover usage consists of converting the value of the loss corporation into ultra safe investments, such as Treasury bonds, and fashions its limitation on the annual application of the long-term applicable Federal rate (in effect at the time of a more than 50% ownership change) to the value of the loss corporation at the time of the change. The limitation formula and its applicability would endure (absent subsequent ownership changes or other special events) for the balance of the Section 172 15-year period outstanding at the time of the ownership change. Assistant Secretary Pearlman has observed that the actual tax carryover annual absorption rate reported by corporations in the real world is significantly less than the current long-term applicable Federal rate and proposes the use of the mid-term rate instead. The House Ways and Means Committee prefers a long-term tax-exempt bond rate. All these approaches assume that notions of fairness or economic reason validate a model according to which a loss entity's business assets are liquidated, its debts paid and then converted into a passive investment company holding governments of varying degrees of conservatism while privileged to serve out its days using its tax carryovers to offset its modest, but assured, interest income stream. The House Committee model mixes the investment company metaphor by using tax-exempt income to absorb the tax carryovers, leading us to conclude that in choosing a limitation rate consistency of principle is not as important as a gut feeling of suitability.

The ABA Proposal model approaches the absorption problem from a different direction, looking instead to what the business community regards as a suitable return on investment in risk-prone enterprises (with operating assets and debt still in place) characteristic of loss corporations. This led to a 24% annual rate to be applied to loss corporation value for a 5-year period, irrespective of the length of the remaining Section 172 period.

The Chicago Bar Association Tax Committee favors the ABA Proposal model, limitation rate and period of utilization. Where true neutrality is impossible by definition, it prefers the reality of adhering to the common and reasonable expectations and practices of the business community. The ABA Proposal does not increase the value of tax carryovers, but it accelerates and shortens their usefulness in line with what our Committee believes is the general disinclination of businessmen to give serious attention to plans in this area extending much beyond 5 years. If the ABA Proposal format should be unacceptable, our Committee suggests that the rate be sharply increased to twice the long-term applicable Federal rate with or without a cut-off period for use in addition to the Section 172 time limit. The acceptability of an enhanced rate and a compressed period for utilization depends upon the extent to which such provisions are deemed not to stimulate the valuing of and trafficking in tax carryovers. Our Committee believes such stimulation will be minimal as it cannot envisage a practical businessman paying more than 7½% to 15% of net operating loss carryovers under the ABA Proposal.[2] We do not regard this as a traffic deserving special Congressional attention.

Triggering Event.

The SFC Proposal regards the necessary event for the imposition of tax carryover limitations as an ownership change consisting of a more than 50% shift (by 5% or more holders) during a 3-year testing period, disregarding certain shifts within related groups and by reason of death, gift, divorce or separation. Our Committee regards this as relatively simple and easily administered were it not for the undue length of the 3-year testing period. We suggest that a full 24-month period is more appropriate in that it relates well with the 2-year period of existing Section 382(a) without its possible short year and a day evasion and

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2) Assume $1,000,000 NOL. Usable $240,000 per annum for 5 years, having a face value of $86,400 in tax savings for each year assuming a 36% effective tax rate, with an aggregate value of $302,400 for the 5 years discounting at 10% simple. We assume that half of the $302,400 would be the maximum theoretical price for the $1,000,000 NOL (i.e., 15%). Considering all the uncertainties of economic life, we suggest that 7½% is the more realistic maximum.

avoids application to gradual shifts occurring over the slow passage of time which are not the targets for regulation as are the more abrupt transfers likely to be effected by loss traffickers.

Value.

The SFC Proposal applies the limitation percentage to the value of the stock of the loss corporation immediately before the ownership change. The ABA Proposal includes any amount paid by the new owners for shareholder debt outstanding more than 2 years prior to the time of ownership change. This better reflects the true value of closely held businesses where shareholder debt is widely recognized as constituting in effect a second class of equity. Our Committee agrees that such debt should be included in equity value, but would confine the included debt to that which is unsecured and not "marketable" so as to assure that true debt does not count. We also suggest that 2 years may be older and colder than necessary. This is essentially a means of excluding insertions of value into a loss corporation in anticipation of increasing its value for tax carryover limitation purposes, that is, an anti-stuffing device. Our Committee contends that in the real world businessmen are not inclined to "stuff" for such purposes, unless deliberately enticed immediately before a sure-fire sale. Consequently, we recommend 1-year as the appropriate period for any and all anti-stuffing measures.

Assistant Secretary Pearlman proposed that any amount attributable to the value of tax carryovers be excluded from corporate value. Our Committee strongly favors avoiding this exclusion in the interests of simplicity and avoiding circularity and mutually dependent variables in a situation where business circumstances and the inherent nature of the limitation proposal impose severe constraints on the separate value of tax carryovers and so render the exclusion unnecessary.

Built-In Gains and Losses.

The SFC Proposal deems built-in losses inherent in high basis/low value assets to be the equivalent of net operating losses and accordingly treats them as subject to limitation, mitigated by a netting out with built-in gains and by a *de minimis* rule which counts only built-in gain or loss from an asset exceeding 25% of the asset's value. The ABA Proposal also would subject built-in losses to limitation. Assistant Secretary Pearlman would expand the built-ins to include "built-in deductions", e.g., depreciation attributable to basis in excess of value, even though he acknowledged that even the SFC Proposal would "entail significant complexity" and "require valuation of a corporation's assets."

In the interest of simplicity, our Committee recommends eliminating all "built-ins" from the legislation. Built-ins are not subject to present Section 382 regulation, but are or can be reached where appropriate by Section 269 and the consolidated return regulations (Reg. §1.1502-15) which we strongly urge be kept in effect. Unless there are demonstrated widespread and uncontestable abuses under the present regulatory system, we maintain that there is insufficient justification for proposing major complexity and opportunity for myriad factual value disputes when no significant legislative purpose will be served.

Successive Changes of Ownership.

The SFC Proposal treats the problem posed by successive ownership changes in a manner which reflects but does not add to the inherent complexity of the subject matter, and our Committee recommends adoption of such treatment.

Capital Contributions.

The SFC Proposal anti-stuffing approach is to remove from corporate value all capital contributions made pursuant to a limitation avoidance plan and to presume that all contributions made within the 2-year period before an ownership change are subject to such proscribed plan (subject, however, to exceptions as regulations may provide).

Our Committee suggests that this approach ignores the hard realities confronting businessmen attempting to keep losing enterprises afloat and the high unlikelihood of them investing and subjecting to the reach of creditors precious cash or other property in the remote hope that they may inflate by some small degree the value of their corporation's tax attributes. Rational economic behavior imposes a cap on this sort of corporate behavior far short of 2 years before a sell-out. We propose that all contributions more than a year before the change be given safe harbor treatment and be accepted as part of corporate value without question and that those made within the 1-year period be subject to scrutiny for purposive stuffing without any presumptions other than those ordinarily attaching to the Commissioner's determinations.

Investment Companies.

The SFC Proposal regards "investment companies", those with at least 2/3 value in "investment assets" before the ownership change, as totally unsuitable for the transmission of tax carryovers. Assistant Secretary Pearlman suggests that the rule be loosened to exclude investment assets from the value of corporations having at least 1/3 of its value in such assets, even though he concedes that there is no real reason for treating an investment company different from an operating company and that there is only a possibly "perceived" abuse which "might affect the public's view of the tax system."

Our Committee sees no authentic legislative purpose which is served by discriminating against an entity because of a merely perceived abuse. The Proposal does not prevent an operating company with tax carryovers from converting to an investment company and then using them, absent an ownership change. It does not prevent such use if the ownership change precedes the operating to investment conversion. We further note the incongruity of adopting a regulatory scheme based upon an investment company model and then totally penalizing such companies under that scheme. Under these circumstances, we recommend that the investment company provisions be stricken from the legislation as ineffectual as well as unjustified and unnecessarily complicating.

Title 11 (insolvency) Cases.

Consistent with some existing case law, the SFC Proposal treats creditors of corporations who take stock for debt in formal Title 11 proceedings as if they were already shareholders so to avoid invoking Section 382 limitations. As a toll for this possible concession, the Proposal would treat interest paid to such creditors during the prior 3-year period as dividends for net operating loss purposes and would treat a subsequent ownership change within the succeeding 2-year period as eliminating all tax carryovers.

Our Committee recommends that in order to avoid encouraging further crowding of bankruptcy court dockets the Proposal be opened to include informal creditor workouts as well as formal Title 11 cases where genuine insolvency is present or pending. We strongly urge the abandonment of the 3-year interest rule, not only in the interest of simplicity, but also to avoid an unnecessary "deemed" transaction of the sort which adopts only the consequence adding to tax revenues (deemed "dividend" out of NOL) and not the consequence diminishing them (deemed "dividend" not giving rise to the corporate dividend received deduction). This type of legislation is difficult to comprehend and might give rise to adverse public perceptions concerning the fairness of the tax legislative process--a perception problem more serious than the merely "perceived" but non-real abuse.

Our Committee also sees no reason to treat the post-insolvency ownership change as different from any other change subject to Section 382 limitation. There is nothing abusive or contrary to ordinary rational business behavior about a group of inexperienced creditors, who suddenly finding themselves the owners of a failed business about which they know little or nothing, to seek new owners who have the know-how, credit or capital to benefit from its ownership. We can see no danger to the public fisc arising from this transaction as would justify its being the occasion for the elimination of tax carryovers beyond the consequences already flowing from the workings of the normal application of the new Section 382 approach and the debt cancellation/insolvency rules recently adopted and presently in effect.

Effective Date.

The SFC Proposal would apply to ownership changes after December 31, 1985, with the ownership testing period to begin January 1, 1986. If enactment should be delayed beyond that date, our Committee recommends that retroactive effectiveness be avoided for a subject so obscured in the public vision by contemporaneous consideration of much grander subjects (viz., Tax Reform, Subchapter C Reform) by the adoption of an effective date no earlier than the enactment date or, for convenience in compliance and administration, the first day of the month immediately following enactment.

Other Provisions.

Our Committee recommends retaining the full application of Section 269 and the consolidated return rules dealing with separate return limitation years and consolidated group change of ownership, which may well be amended so as to complement and harmonize with the new approach. We also recommend that the legislation and its official history avoid any limiting references to the rule of the Libson Shops case. Considerations of simplicity and ease of administration and self-assessment have led us to recommend avoiding the complexities of ultra-sophisticated anti-abuse rules. Consequently, existing legislative and judicial anti-abuse provisions should be kept intact. What they lack in ready predictability of specific application may be compensated by the very breadth of their expression (and possible application) and the high degree of their acceptance and majesty in the eyes of the taxpaying public.

HEARINGS
BEFORE THE
SENATE FINANCE COMMITTEE
ON H.R. 3838
STATEMENT OF WALTER E. AUCH, CHAIRMAN OF THE CHICAGO BOARD OPTIONS EXCHANGE

I. INTRODUCTION

The Chicago Board Options Exchange, Inc. (the "CBOE") is a registered national securities exchange subject to the regulatory authority of the Securities and Exchange Commission. It is the world's largest market for the trading of put and call options to sell and buy shares of corporate stock. The CBOE currently lists options on the common stocks of approximately 150 of the nation's largest corporations, as well as currency options, debt options, and the leading option on a stock index, the S&P 100. The membership of the CBOE includes virtually all of the major national securities firms as well as many smaller firms located throughout the country, and close to one thousand broker/dealers who transact business on the CBOE trading floor in Chicago as either market makers or floor brokers.

The CBOE has worked with Congress and the Treasury Department on the taxation of options products at the legislative and regulatory levels since 1981, and will continue to work actively toward creating the best possible system for the taxation of exchange-listed options.

The CBOE's interest in H.R. 3838 is based upon its desire to have the statutory amendments suggested in a legislative proposal (the "CBOE Legislative Proposal") that was filed with the Treasury Department on January 17, 1986 added to H.R. 3838.

The CBOE Legislative Proposal contains five proposals designed to clarify and simplify the taxation of derivative investment products such as stock options. Three of the proposals relate to the taxation of investors, and the remaining two proposals relate to the tax treatment of professionals. The changes are implemented by making minor, and in many cases technical, modifications of existing provisions of the Internal Revenue Code. We believe that the proposed changes should not have any significant revenue effect and that they are supported by sound tax policy.

II. INVESTOR PROPOSALS

A. **Qualified Covered Calls**. Existing law contains an exception from the straddle rules for certain covered call options that do not substantially reduce the writer's risk of loss on the underlying stock. One of the key prerequisites to the "qualified covered call exception" is that the call not be deep-in-the-money. Current law identifies calls that are not deep-in-the-money by means of a complicated benchmark system. When this system was enacted in 1984 its proponents felt it would be easier to use than the 15%-in-the-money rule upon which it was based. Experience has proven, however, that the benchmark system is quite complicated, thus our proposal would return to the 15%-in-the-money rule originally proposed in 1983.

Use of the 15% rule will increase the number of calls eligible to be treated as qualified covered calls. To ensure that this does not create any new straddling opportunities, the proposal would also strengthen the existing year-end rule by making it apply to both stock and option losses rather than just to option losses as under current law.

The proposal would also modify two rules applicable only to in-the-money qualified covered calls. We believe that the current rules, which recharacterize certain losses and suspend the holding period of stock in certain circumstances, are unnecessarily harsh.

B. **60/40 Treatment For Investor Stock Options**. Under current law, all exchange-traded option contracts are subject to either Code § 1256 or Code § 1092. An option subject to

Code § 1256 (a "section 1256 contract") is marked to the market at year end, and any gain or loss is treated as 60% long-term capital gain or loss and 40% short-term capital gain or loss. All options except investor-held equity options are section 1256 contracts. Investor-held equity options are subject to the loss deferral rules of Code § 1092. There is no sound economic or tax rationale for treating equity options differently than all other options, thus under the CBOE Legislative Proposal investor-held pure equity options would be section 1256 contracts, thus would be on a par with all other derivative investment products for tax purposes. The CBOE Legislative Proposal would not entirely eliminate all disparities in the tax treatment of investor-held equity options, however, since equity options that are offset by stock positions would not be eligible for 60/40 treatment. These options are excluded because we believe that it is inappropriate to subject investors to the complexities of the rules dealing with mixed straddles.

C. **Confirmation of the Validity of the Married Put Rule; Extension to "Married Calls" and Straddles Generally.** There is presently a great deal of confusion in the investment community regarding the continued vitality of the married put rule of Code § 1233(c). That rule permits an investor who simultaneously buys a put and the stock that will be delivered if the put is exercised to avoid the termination of holding period that would otherwise occur under the short sale rule of Code § 1233(b). The legislative histories of the Economic Recovery Tax Act and the Tax Reform Act of 1984 do not specifically mention this rule, yet some people believe that it has been overridden by the temporary straddle regulations issued by the Treasury Department. We do not believe that Congress could have intended to repeal Code § 1233(c) in this indirect manner. Accordingly, we believe that the validity of the married put rule should be confirmed.

The married put rule is a simple means of taxing certain straddles, and we believe that its principles should be extended to married calls and to straddles generally. Accordingly, the CBOE Legislative Proposal contains a provision authorizing the Treasury Department to write straddle regulations based upon these principles.

III. PROPOSALS RELATING TO PROFESSIONALS

A. **Options Dealer Account**. Current law provides taxpayers that hold mixed straddles with two principal means of accounting for those transactions. The first, known as "straddle-by-straddle identification," requires the taxpayer to identify each individual straddle, and to determine gain or loss from the straddle by offsetting gains and losses realized on the individual positions. The minimum effective tax rate for this method is 32%. Under the second method, the "mixed straddle account," the taxpayer places all positions of a particular symbol in an account, marks each position to market each day, then offsets those gains and losses. At year end the daily net gain or loss is netted to determine annual gain or loss from that particular symbol. The minimum effective tax rate on this account is 35%. The mixed straddle account was designed for taxpayers who cannot easily comply with the straddle-by-straddle identification method because of the large number of trades they enter each day. Experience has shown, however, that many options dealers do not have, and are unable to obtain, the information necessary to accurately report their trading income using either of these methods.

The CBOE Legislative Proposal offers options dealers a third alternative known as an "options dealer account." All positions in this account would be marked to market upon being placed in the account and at year end. At year end all realized gains and losses, and all gains and losses resulting from marking to market, would be netted, and net gain or loss would be treated as 57% short-term capital gain or loss and 43% long-term capital gain or loss, resulting in a net effective tax rate of 37%. This split between long-term and short-term capital gain or loss would be used even if the maximum rates are changed as proposed under H.R. 3838. We believe that this rate is high enough to protect the fisc, yet low enough to be a viable alternative to options dealers who are attracted by its administrative ease.

B. Alternative Capitalization Method. Code § 263(g) requires that interest and carrying charges properly allocable to positions of a straddle be capitalized. The statute seems to require that the allocation be made on a position by position basis and this reading is supported by the temporary straddle regulations which require allocation on an account-by-account basis. Many options dealers and commodity traders finance their trading business as a whole rather than financing individual positions or straddles, thus cannot accurately allocate interest or carrying charges as required. Under the CBOE Legislative Proposal, options dealers and commodity traders would determine the amount of interest and carrying charges that must be capitalized on a business-wide basis. Persons using this method would also be entitled to offset any net ordinary income against any net capital loss from trading activities so as to avoid taxation of uneconomic gains.

Finally, the relationship between Code § 263(g) and (h) would be clarified under the CBOE Legislative Proposal.

IV. SUMMARY

In summary, the CBOE is of the strong view that these provisions are revenue neutral, promote simplicity, and are otherwise supported by sound tax policy.

Written Statement Submitted on Behalf of the City of Chicago to The Committee on Finance, United States Senate, Respecting Municipal, Tax-Exempt Financing in Tax Reform

February 18, 1986

The City of Chicago is alarmed at the deep cuts in and stifling restrictions on tax exempt financing imposed by H.R. 3838. These bond volume limitations and use restrictions would cut to the heart of Chicago's plans to meet its governmental responsibilities to all of its citizens. In particular, we are concerned about housing, solid waste disposal, and redevelopment, as well as those new rules touching all bonds, including arbitrage rebate, the timing of proceeds use, and the limitations on advance refundings. In addition the effective date of H.R. 3838 ought to be postponed until final enactment of Tax Reform, if any.

Stated simply, we ask the Senate not to change municipal bond law at all this time around. Bonds have been addressed repeatedly in recent years. IDBs have been subjected to a volume cap and sunsetted. In addition, cities are being beseiged by cuts in most other federal programs. The modest (one might say infinitesimal) federal revenue loss from maintaining present law, as compared with H.R. 3838 (estimated to be $3 billion over five years), does not justify the enormous disruption to cities and towns across America which H.R. 3838 promises and has already begun to deliver. However, if bonds are included in this Committee's Tax Reform package, we urgently request the following departures from H.R. 3838.

III.

Redevelopment

With the disappearance of urban renewal as a federal priority and program, local governments have sought local solutions to dealing with conditions of blight. It is in the national interest that cities and towns revitalize themselves. We are prepared to do that, but we need the modicum of federal help provided by tax exempt financing. In Illinois we have a useful tool - tax increment financing - to assist us. About 35 other states have that tool as well. We are asking this Committee to keep that tool realistically available by leaving us the ability to use it in conjunction with tax exempt bonds.

A. What is Tax Increment Financing? Tax Increment Financing (TIF) is a municipal funding source which permits public-private redevelopment partnerships to stop the spread of blight and reverse the decline in real property tax bases. The public expenditures include such public purpose activities as property assembly (including land acquisition and structure demolition), public works, streets, utilities, relocation, rehabilitation, and administrative overhead. By fostering redevelopment, these projects save and revitalize older city centers and downtown areas to the benefit of all property tax payers.

The central feature of TIF legislation is that it allows a municipality to institute an urban development program in blighted or conservation areas by capturing, as a funding device for payment of redevelopment costs, those real property taxes (and in some cases other state and local taxes like sales taxes) derived from redeveloped property which exceed the taxes received from the property prior to redevelopment. As an example, assume that a municipality has a redevelopment project area which qualifies as a blighted or a conservation area. Prior to redevelopment the area produces $1,000,000 annually in real property taxes. If this area is redeveloped, it is projected that it will produce $3,500,000 annually. The difference of $2,500,000 is the tax increment, which anticipated future revenue justifies current expenditures and borrowing therefor.

TIF was first adopted in California in the early 1950s. Since then, it has spread eastward to Utah in 1953, Oregon in 1961, Minnesota in the 1960s, and Iowa in 1969. The Illinois act became effective in 1977. Today, there are at least 35 states in all regions of the United States which have adopted some form of tax increment legislation. Among the states which have had extensive experience in its use are California, Florida, Kansas, Illinois, Iowa, Minnesota and Wisconsin.

In order to avoid abuses, TIF statutes generally require public hearings and findings that the (a) redevelopment project area on the whole has not been subject to growth and investment by private enterprise and would not reasonably be anticipated to be developed without the adoption of the redevelopment plan; (b) all of the parcels in the redevelopment project area must benefit from the redevelopment; and (c) that the project conforms to a comprehensive plan for the development of the municipality as a whole. Finally, in Illinois the TIF statute provides that a Redevelopment Project Plan and Redevelopment Project must terminate no later than 23 years from the date of the adoption of the ordinance approving the Redevelopment Project Area. Bonds can be issued for a maximum term of 20 years, or for the remaining term of the Project.

The Illinois legislation has provided the vehicle for major redevelopment projects throughout the state with at least 25 projects underway. In 1984, Chicago adopted its first Redevelopment Plan and Project for the North Loop. This project is located in the northeast sector of the central downtown area, known as the Loop. For 1986 and 1987 this project contemplates the expenditure of approximately $100,000,000 of public redevelopment costs and over $400,000,000 in private investment. In addition, Chicago has four other major projects in planning with more to come.

B. What Has H.R. 3838 Done To Tax Increment Bonds? As of January 1, 1986, the effective date of H.R. 3838, the tax-exempt status of many tax increment bonds has, for the first time since 1973 (Revenue Ruling 73-481), been seriously restricted. The Bill contains severe limitations on the issuance of tax exempt bonds used in urban redevelopment, unless the bond proceeds are to be used for the construction of public improvements such as roadways, sewers, curbs, gutters, and the like, which are intended for use by the general public. Bond proceeds used for other activities in a tax increment district, like land acquisition and site preparation, must both qualify under H.R. 3838, now an impossible task, and are subject to a tiny volume cap.

The new unified volume limitation (cap) is structured somewhat like the one which exists under current law, except that more bonds are subject to its limits, while the volume limit remains at approximately the same level. Bonds subject to the unified volume limitation include most non-essential function bonds for which tax exemption is permitted and the non-governmental portion (in excess of $1 million) of essential function bonds. Specifically, the volume limitation applies to (1) exempt facility bonds (other than bonds for certain airport, dock and wharf facilities), (2) qualified mortgage bonds, (3) qualified veterans' mortgage bonds, (4) small issue bonds, (5) section 501(c)(3) organization bonds, (6) qualified student loan bonds, and (7) Qualified Redevelopment [tax increment] Bonds ("QRBs").

The volume limitation for all bonds subject to the cap within a state is $175 per capita. $25.00 of this amount is set aside for §501(c)(3) organizations. $75 is allocated to housing. The remaining $75.00 per capita remains for small issue bonds, qualified student loan bonds and QRBs, $6.00 of which is specially set aside for QRBs. As can be seen on the attached chart, this cap set aside, even if it were available under H.R. 3838 (which for a variety of technical drafting errors it is not), is woefully inadequate.

The net result of the Bill is that QRBs, i.e., bonds used in redevelopment areas designated under state law for land acquisition, site preparation, etc., are classified not as public purpose or governmental bonds, but as non-essential function bonds and surrounded with impossible qualification requirements and a suffocating volume limitation. Contrary to the Bill's conclusion, these are public purpose bonds, vital to the redevelopment of older cities and towns of America and ought to be reasonably available to those communities. More importantly, they are repaid entirely by local governments out of state and local tax revenues. As such, they are exactly like traditional General Obligation or Revenue Bonds and ought to be treated accordingly. Finally, because of the inherent statutory, practical and political limitations on their use, they present absolutely no volume abuse threat.

The staffs of the Ways and Means Committee and the Joint Committee on Taxation have repeatedly and consistently opposed the treatment of tax increment bonds as governmental (or, in the nomenclature of the H.R. 3838, essential function bonds) on the ground that they are abusive Industrial Development Bonds ("IDB"), in spite of the following numerous and clear distinctions between tax increment bonds and IDBs:

1. Tax increment financing is a tool to permit redevelopment to occur in blighted and conservation areas in cities where there is a stagnant or declining tax base, pursuant to an express finding that redevelopment would not otherwise occur. IDB financing may be used in any locality.

2. Tax increment bond proceeds are used to pay for traditional public costs, such as streets, sidewalks, off-site utilities and the acquisition of properties to remove blighted conditions and create a feasible redevelopment project. IDB financing makes tax exempt loan proceeds directly available

to property owners for construction of new facilities, commercial, industrial and residential.

3. The source of funds used for tax increment financing is the new tax revenues generated by the redevelopment. These new tax revenues would not come into being but for the redevelopment. Debt service on tax increment bonds are paid entirely by local governments from state and local taxes. The IDB is similar to a customary loan transaction which is repaid by funds of the developer.

4. In tax increment financing the city is the sole responsible borrowing party and continues to remain responsible for the generation of the tax revenue to pay debt service on the obligations. In IDB financing, after the closing of the bond transaction, the city has no further responsibility. The obligation is that of the private user.

5. In tax increment financing there is no tax break to the developer. The developer must pay taxes on the assessed value of the property, which are based on the fair market value of the property. In IDB financing the developer pays interest at a tax exempt rate.

IV.

Recommended Action

With the numerous recent changes in the bond provisions of the Internal Revenue Code ("IRC"), including the sunsetting of IDBs, and the very small revenue impact of the H.R. 3838 bond provisions compared to current law ($3 billion over five years), there is no reason that Tax Reform needs to address bonds at all.

The only clarification necessary to "current law," respecting tax increment bonds, is to ensure that the Committee Report to the Technical Corrections to the 1984 Act does not introduce a 5% private use test in IRC § 103(o), where none was contemplated by Congress.

In the event the Senate does address bonds, it should:

1. Remove the volume restriction from housing bonds;
2. Permit solid waste disposal facilities to be financed in public-private partnerships with tax exempt bonds without volume limitation;
3. Require that public purpose tax increment bonds, repaid entirely by local governments from state and local tax revenues, are categorized as "essential function bonds," and therefore tax-exempt without volume limitation;
4. Eliminate or substantially ameliorate the effect of those technical restrictions on all bonds, including arbitrage rebate, the 30 day/5% proceeds use rule, and the limitations on advance refundings, which are new in H.R. 3838; and
5. Postpone the effective date of H.R. 3838 for all bonds until final enactment of Tax Reform, if any.

(660/AA)

I.

Housing

The use of tax exempt bond proceeds to provide housing for low and middle income citizens of Chicago is a high priority project for the City. As with other, older cities, Chicago must encourage the replacement of its housing stock if it and its neighborhoods are to maintain their vitality. As can be seen from the attached chart, Chicago proposes to issue almost $1 billion in housing bonds during 1986 and 1987. The new unified volume limitation of H.R. 3838 would cut that figure in half. In the absence of other housing programs, the use of tax exempt bond proceeds to meet our housing needs is essential.

II.

Solid Waste Disposal

H.R. 3838 makes it impossible to finance solid waste disposal facilities with tax exempt bonds, in the kind of public-private partnership projects, which will be necessary in the future to meet our needs. The attached chart shows Chicago's projection of $500 million in bonds for solid waste disposal programs in 1986 and 1987. This is only the beginning. As with other major cities, land fill has become a vanishing alternative. The capital costs of solid waste disposal for the balance of this century will be enormous. These costs must not be increased by requiring these projects to proceed without necessary private participation and tax exempt financing.

CITY OF CHICAGO
TAX EXEMPT BOND SHORTFALL
FROM H.R. 3838 FOR
1986 AND 1987

($ millions)

Bonds	3838 Cap	Projected Bonds 1986	Projected Shortfall 1986	Projected Bonds 1987	Projected Shortfall 1987	Projected Bonds '86 & '87	Total Shortfall '86 & '87
Housing	217.5	459.0	241.5	394.0	176.5	853.0	418.0
Qualified Redevelopment (TIF)	23.0	150.0	126.8	80.0	56.8	230.0	183.6
Total Other (IDB's, etc.)	194.5	177.0	(17.5)	183.0	(11.5)	360.0	(29.0)
Solid Waste Disposal	0	250.0	250.0	250.0	250.0	500.0	500.0
Parking	0	9.0	9.0	9.0	9.0	18.0	18.0
Totals	435.0	1045	610	926.0	481.0	1961.0	1090.6

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*Shortfall is projected bond volume less H.R. 3838 cap.

TESTIMONY OF THE CHURCH ALLIANCE

SENATE FINANCE COMMITTEE

TAX REFORM HEARINGS OF JANUARY 29, 1986--FEBRUARY 6, 1986

I. INTRODUCTION

On December 19, 1985, the United States House of Representatives passed H.R. 3838, 99th Cong., 1st Sess. 131 Cong. Rec. 12,427 (1985) (sometimes hereafter referred to as the "Bill"), that would substantially overhaul the federal system of taxation. Certain provisions of H.R. 3838 ignore the fact that churches, synagogues and conventions or associations of churches or synagogues (hereinafter referred to as the "Church" or "Churches") are different from for-profit employers in terms of their organization, operation and mission. The Church Alliance, a coalition of the chief executive officers of Church pension boards which provide retirement and welfare benefits to ministers and lay workers, would, through this testimony, register its concern and dismay with such provisions. More specifically, H.R. 3838 would:

- Repeal the tax exemption that Church pension boards and their wholly owned affiliates have been accorded under the Internal Revenue Code since 1913 and tax such boards and their affiliates as insurance companies;

- Define the "church," for certain purposes, in a manner that ignores both historic Church boundaries and the manner in which Churches carry out their mission through agencies; and

- Impose unnecessary, complex and substantial administrative costs and burdens on the Church, including its Church pension boards and ministry organizations, which will result in decreased benefits to ministers and lay workers and cut backs in Church missions and benevolency programs.

The Church Alliance believes that the provisions in question are ill-advised and inappropriate as applied to Churches, involve only nominal revenue, and would vastly restrict and complicate the ability of Churches to fulfill their missions and goals.

II. THE CHURCH ALLIANCE

As noted above, the Church Alliance is a coalition of the chief executive officers of Church pension boards acting on behalf of Church benefit programs. These benefit programs serve the ministers and lay workers of 29 historic, religious denominations with over 62,000,000 members from Protestant, Catholic, Jewish and other main line faiths. These Church benefit programs are among the oldest source of employee benefits in this nation. Retirement programs maintained by the pension boards of several Church Alliance members date from the 1700s. The median age of the retirement programs represented in the Church Alliance is in excess of 50 years.

Church benefit programs began in recognition of a religious denomination's mission to care for Church workers in their advanced years. Church benefit programs, in their early history, cared for retired, disabled or impoverished ministers and their families as particular cases of need were identified. As time passed, these denominations wisely decided to plan for the benefits needs of their ministers and lay workers on a current and systematic basis. Today, Church benefit programs provide benefits to ministers and lay workers employed in all forms of pastoral, healing, teaching, preaching, and evangelistic ministries and missions, including local churches, hospitals, universities, retirement homes, inner city agencies, seminaries, orphanages, boys' and girls' camps and day care centers (hereinafter sometimes referred to as "ministry organizations").

The Church pension boards represented through the Church Alliance provide a critical and essential service to their respective denominations by the provision, administration and investment of funds set aside for the retirement and welfare benefits of ministers and lay workers. A Church pension board is controlled by or associated with the Church of which it is a part, in accordance with the polities, beliefs and practices of such Church. In hierarchical denominations (i.e., the Catholic and Episcopal Churches), this control is exercised through one or more Church leaders or through what might be called parent organizations. Congregationally organized denominations are coalitions of autonomous Church organizations voluntarily linked together out of common faith, cooperation, mission and heritage. In congregational denominations, Church pension boards are associated with these Church organizations in fulfilling the overall mission and ministry of their particular denomination. However, each Church pension board, whether in a hierarchical or congregational setting, is an integral and component part of a Church, and serves only the Church ministry organizations within the boundaries of its respective denomination.

Church pension boards have been granted exemption from income tax as organizations described in what is now section 501(c)(3) of the Internal Revenue Code of 1954, as amended (the "Code"). Tax exemption has been granted in recognition of the fact that activities of Church pension boards are and historically have been an integral part of the exempt activities of the Church in providing benefits for ministers and lay workers. Many Church pension boards received their initial endowments from generous gifts made by well-known philanthropists. Today Church pension boards still count on the gifts and bequests of interested individuals to assist the boards in providing benefits to ministers and lay workers during their ministries and in retirement. Recognition of tax-exempt status for Church pension boards is essential in order to insure the continuation of such gifts and bequests.

III. CONSTITUTIONAL CONSIDERATIONS

The First Amendment to the Constitution of the United States provides that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . . ." This sentence, containing what have become known as the "Establishment Clause" and the "Free Exercise Clause," is the cornerstone for separation of church and state in our society and a guarantee that every denomination will be equally at liberty to exercise and propagate its beliefs.

In 1971, the United States Supreme Court enunciated a three-part test that a statute must pass in order to avoid a violation of the Establishment Clause. Lemon v. Kurtzman, 403 U.S. 602 (1971). The Lemon v. Kurtzman test requires that a federal statute affecting Churches (i) must have a secular legislative purpose, (ii) must not advance or inhibit religion by its principal or primary effect, and (iii) must not foster an "excessive governmental entanglement with religion" (citing Walz v. Tax Commission, 397 U.S. 664, 674 (1970), as authority for the third requirement).

The Church Alliance does not today argue the unconstitutionality of the provisions of H.R. 3838 addressed herein - it understands the Baptist Joint Committee on Public Affairs will address that issue in depth. The Church Alliance's point is simply this: the First Amendment of the Constitution and the Supreme Court's test ennunciated in Lemon v. Kurtzman, supra, recognize that Churches are unique and must be treated differently from private sector organizations. The provisions of H.R. 3838 discussed hereafter must be viewed against this backdrop of constitutional requirement and history.

IV. PRIOR LEGISLATION DEALING WITH CHURCH PLANS

In 1974, the Congress enacted the Employee Retirement Income Security Act of 1974 ("ERISA"), the most comprehensive and sweeping reform of benefits legislation in this country's history. In that legislation, Congress exempted "church plans" from the complex government regulation imposed upon other retirement and welfare plans. The Congress' concern regarding federal regulation of church plans was most clearly expressed by the Senate Finance Committee in the following discussion of the plan termination insurance provisons contained in Title IV of ERISA:

BEST COPY AVAILABLE

> The committee is concerned that the examinations of books and records that may be required in any particular case as part of the careful and responsible administration of the insurance system might be regarded as an unjustified invasion of the confidential relationship that is believed to be appropriate with regard to churches and their religious activies.

S. Rep. No. 383, 93d Cong., 1st Sess. 81 (1973). This excerpt from the Senate Report on ERISA reflects the Congress' view that church plans must be treated differently from similar plans sponsored by for-profit employers.

The 1974 church plan definition contained in ERISA was deficient in one major respect - but for a short transition period, Church benefit programs that included employees of Church agencies would lose their status as "church plans." In the Multiemployer Pension Plan Amendments Act of 1980 (the "MPPA"), Congress recognized and rectified this deficiency by revising the definition of "church plan." Today, a benefit plan maintained by a Church pension board for employees of a Church agency is deemed to be a "church plan" if such board or agency is controlled by or associated with a Church. The revised "church plan" definition contained in Code section 414(e) and ERISA Section 3(33), thus, reflects Congress' recognition that hospitals, universities, retirement homes, seminaries, mission boards, auxiliaries, day care centers and other similar pastoral, teaching and healing ministries are part of the Church, as long as these organizations are controlled by or associated with the Church.

Certain provisions of H.R. 3838 (discussed hereafter) ignore the historic boundaries of religious denominations that were clearly recognized in 1980 by the Congress in the revised "church plan" definition. The Church Alliance submits that nothing has happened since that date to warrant such a change. The Church Alliance urges the Senate Finance Committee to oppose enactment of those provisions of H.R. 3838 described hereafter that would have a significant adverse impact on the provision of benefits to ministers and lay workers of Churches and their ministry organizations.

V. ANALYSIS OF H.R. 3838

Certain provisions of H.R. 3838 represent a multiple attack on the traditional boundaries established with respect to historic, main line religious denominations in this country. This multiple attack would:

- Eliminate the tax-exempt status of most Church pension boards and tax Church pension boards (and, thus, the Churches of which they are a part) as insurance companies in connection with the provision of compensatory benefits to ministers and lay workers (Bill Section 1012);
- Tax Church pension boards on dividends received from corporations in which the Church is a five-percent or greater shareholder (Bill Section 311);
- Severely restrict the ability of the Church, including its ministry organizations, to provide appropriate and adequate levels of retirement benefits to ministers and lay workers by limiting the amount that may be contributed to retirement income accounts (Bill Section 1102);

- Effectively foreclose the availability of individual retirement accounts ("IRAs") to ministers and lay workers who participate in Church retirement income account programs (Bill Section 1101);
- Impose complex, inappropriate, and unnecessary anti-discrimination rules on the welfare plans of all Church organizations and the retirement programs of some (Bill Sections 1151 and 1113);
- Effectively foreclose the ability of Churches to provide vested supplemental compensation to ministers and lay workers through unfunded deferred compensation programs (Bill Section 1104); and
- Potentially prevent some Church pension boards from providing retirement benefits to their ministers and lay workers through the purchase of deferred annuity contracts (Bill Section 1135).

If these provisions are enacted, Churches will be forced to decrease benefits provided to their ministers and lay workers, or cut back their participation in Church missions, ministries and benevolency programs, or both.

On a positive note, Bill Section 144 affirms the right of ministers to deduct all of the mortgage interest and taxes attributable to their personal residences. In addition, Bill Section 1122 will ensure that ministers and lay workers of Churches that maintain Code section 403(b)(9) retirement income accounts will not be taxed on benefits provided through such accounts until such benefits are actually received, while Bill Section 1585(c) would allow a "window" period within which churches and their ministry organizations would be able to revoke elections made under Code section 3121(w). The Church Alliance believes Bill Section 1585(c) should be expanded to include a similar "window" period for ministers.

A. Bill Sections 1012 and 311 - Taxation of Church Compensation Programs.

1. Taxation of Commercial-Type Insurance Activities. Bill Section 1012 would deny tax-exempt status to many organizations that are currently tax-exempt if a substantial part of the organization's activities consist of providing what H.R. 3838 has labeled "commercial-type insurance."[1] Under the Bill, "commercial-type insurance" is broadly defined to include any insurance of a type provided by commercial insurance companies. For this purpose, the issuance of an annuity contract is to be treated as the provision of insurance. Many Church pension boards will either lose their tax-exempt status or be taxed on their "commercial-type insurance" activities if Bill Section 1012 becomes law.

The discussion of Bill Section 1012 in the Report of the Committee on Ways and Means of the House of Representatives on H.R. 3838, H. Rep. No. 426, 99th Cong., 1st Sess. 664 (1985) (the "House Report") states that the provision of commercial-type insurance by a tax-exempt organization is an activity "whose nature and scope is so inherently commercial that tax-exempt status is inappropriate." The House Report also notes that some tax-exempt organizations may have a competitive advantage over commercial insurers who do not have tax-exempt status. Id. Although the Church Alliance understands the concerns expressed in the House Report, such concerns are totally inappropriate when applied to Church pension boards.

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[1] If no substantial part of a tax-exempt organization's activities consists of the provision of "commercial-type insurance," Bill Section 1012 would tax the "commercial-type insurance" activities as an unrelated trade or business but, in lieu of the usual tax on unrelated trade or business taxable income, the "commercial-type insurance" activities would be taxed under the rules relating to insurance companies set out in Subchapter L of the Code.

A Church pension board is the Church performing the critical and essential Church function of providing compensatory benefits to its ministers and lay workers. Congress expressly recognized the connection between a Church and its related pension board in the current "church plan" definition contained in Code section 414(e). Church pension boards are not engaged in "commercial-type insurance" activities. Indeed, they merely provide retirement and welfare benefits to ministers and lay workers of their own denomination. This special nexus between a Church pension board and its ministers and lay workers is not shared by commercial insurance companies. In fact, the denominational restrictions under which Church pension boards operate prevent them from providing benefits to members of the public at large. Thus, Church pension boards do not and cannot compete with commercial insurance companies. To the extent that so-called "insurance activities" are carried on by a Church pension board, such activities are merely the Church taking care of its own, out of its own pocketbook.

It is interesting to note that the House Report recognizes that an employer's provision of insurance or annuities for its employees through Code section 401(a) qualified plans is not a "commercial-type insurance" activity. Id. at 665. Although some Church pension boards provide a portion of their ministers' and lay workers' retirement benefits through such qualified plans, many Church pension boards have traditionally provided such benefits to ministers and lay workers through tax sheltered annuities that are today described in Code section 403(b)(9) as "retirement income accounts." The Code section 403(b)(9) retirement income accounts provided through these Church pension boards are in purpose no different than Code section 401(a) qualified plans, i.e., the provision of retirement benefits for employees. If the provision of retirement benefits under a Code section 401(a) qualified plan is not to be considered a "commercial-type insurance" activity, the Church Alliance submits that the provision of retirement benefits under Code section 403(b)(9) retirement income accounts should be similarly viewed.[2]

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[2] Some Churches began to use tax sheltered annuities, the predecessor of retirement income accounts, after they were added to the Code in 1942 as one retirement benefit vehicle for tax-exempt employers. These Churches have found no reason to change to another type of benefit program, especially given the momentum obtained from years of administering their retirement programs in a particular fashion. In addition, Church retirement income accounts are simple to implement and administer. Many Churches and ministry organizations are small operations with one or two employees where the simplicity of retirement income accounts is attractive given their limited personnel and resources. Retirement income accounts may also be simpler to administer in some congregationally organized denominations where benefit portability is a problem due to the Church's lack of control over a Church's or ministry organization's decision to provide or not provide retirement benefits. For a discussion as to why anti-discrimination rules are inappropriate for the retirement programs of all Churches and ministry organizations, see infra pages 18 to 21.

Some Church pension boards provide certain types of welfare benefits (e.g., death, disability and medical) on a self-funded basis. This activity has historically been deemed to constitute a part of the Church's exempt function and, thus, funds accumulated for this purpose have not been subject to federal income taxation. The provision of benefits in this fashion is virtually identical to the provision of the same types of self-funded benefits by a for-profit employer through a tax-exempt Code section 501(c)(9) trust. Because Church pension boards have been able to provide these benefits on a self-funded, tax-exempt basis under Code section 501(c)(3), there has been no need for Church pension boards to subject themselves to the complication and administrative expense associated with providing such benefits through a Code section 501(c)(9) trust. The Church Alliance submits that it is patently unfair to allow for-profit employers to provide welfare benefits on a self-funded, tax-exempt basis through a Code section 501(c)(9) trust while taxing a Church pension board's provision of these same types of self-funded benefits. Bill Section 1012 would have this result if not changed.

Although a provision similar to Bill Section 1012 was contained in the Treasury's initial report to the President on tax reform ("Treasury I"), this provision was removed in the President's own tax reform proposal (the "President's Proposal"). The Church Alliance believes the deletion of this provision in the President's Proposal was appropriate and urges the Senate Finance Committee not to tax Churches under the guise of taxing "commercial-type insurance" activities.

2. Taxation of Dividends Received by Tax-Exempt Entities That are Five Percent or More Owners. Bill Section 311 would require a tax-exempt organization to pay taxes on a percentage of dividends it receives from a corporation in which such organization is a five-percent or more shareholder, if the corporation claims a deduction with respect to such dividend payment. The dividend income received by the organization would be treated as unrelated business taxable income under Bill Section 311. A tax-exempt organization and one or more other tax-exempt organizations would be treated as one organization for purposes of the five-percent or more shareholder rule if such organizations have significant common purposes and substantial common membership, or if they have, directly or indirectly, substantial common direction or control.

Bill Section 311 is unworkable because under its aggregation rule it will be virtually impossible for a Church pension board to know if it is a five-percent or more shareholder in a particular corporation. In contrast, this problem does not exist for the for-profit employer that maintains a qualified plan or plans, because that employer will be able to monitor the plan's investment portfolio to ensure that dividends paid to the plan will not be subject to tax as unrelated business taxable income, unless such result is desired.

In addition to Bill Section 311 being unworkable in the context of Church and Church pension board operations, there is no logic in eliminating a portion of the two tier tax on corporate income by giving the taxable, corporate payor of dividends a deduction for dividends paid, and then imposing a new single level of tax on otherwise tax-exempt organizations. In so doing, the tax burden is simply being moved from a taxable to an otherwise non-taxable organization. The Church Alliance, therefore, urges the Senate Finance Committee to exempt dividends received by Church pension boards from taxation.

B. Bill Section 1102 - Cap on Retirement Income Account Contributions.

Under Bill Section 1102, the maximum amount that an employee may elect to defer for any taxable year under Code section 401(k) plans would be limited to $7,000.[3] The House of Representatives evidently assumed that the same cap was appropriate for tax sheltered annuities, and, thus, Church retirement income accounts. Whatever the merits are of limiting deferrals into Code section 401(k) plans, the Church Alliance submits that imposing the same deferral cap on Code section 401(k) plans and Church retirement income accounts has no logical foundation.

The only real similarity between Code section 401(k) plans and retirement income accounts is that both generally involve salary reduction. However, the rationale for the two provisions and their uses by employers meet distinctively different needs. Church retirement income accounts and their predecessor tax sheltered annuities have existed in the Code since 1942 when Congress recognized that tax-exempt employers lack a tax-motivated incentive to provide retirement benefits for their employees. Thus, these accounts and annuities are and have been made available since inception for use by employees who want to provide for some level of retirement income protection when faced with their employer's inability to do so. In contrast, since Code section 401(k) plans were sanctioned by statute in 1978, employers have been able to shift the pre-tax cost of providing retirement benefits from the employer level to employees. No such cost shifting has occurred in connection with Church retirement income accounts because the incentive to provide benefits has always been with the employee. For-profit employers also may and many times do use Code section 401(k) arrangements to provide benefits that supplement other employer-sponsored programs. In sharp contrast, retirement income accounts are in many instances the only means by which retirement benefits are provided by Churches using this form of benefit provision.

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[3] The Bill provides a limited exception to the $7,000 annual limit in the case of employees of educational organizations, hospitals, home health service agencies, and Churches. Under this exception, any eligible employee who completes 15 years of service with an employer will be permitted to make additional salary reduction contributions of up to $3,000 in each year with an aggregate contribution limit of $15,000.

The House Report indicates that the $7,000 cap is needed for tax sheltered annuities because individuals whose employers make contributions to such annuities pursuant to employee salary reduction agreements under Code section 401(k) may elect to save up to $30,000 per year, while an individual who is employed by a tax-exempt organization that does not offer a salary reduction arrangement is limited to a $2,000 IRA contribution. House Report, at 706. The House Report indicates that the proposed limitation on contributions to tax sheltered annuities will reduce the extent of this purported "inequity." Id. The rationale used in the House Report in support of a $7,000 cap for contributions to tax sheltered annuities breaks down when applied to Church retirement income accounts. Church retirement income accounts are in most instances not "offered" through employer action, but rather are made available through employee election and initiative.

As stated previously, Church retirement income accounts are the only means by which retirement benefits are generally provided by many Churches and ministry organizations using this form of benefit program. Thus, it is inequitable and inappropriate to apply the same cap to Church retirement income accounts that applies to Code section 401(k) plans. The Church Alliance therefore urges the Senate Finance Committee to continue to allow contributions to Church retirement income accounts to be governed by present law.

C. Bill Section 1101 - IRA Coordination with Other Salary Reduction Arrangements.

Under the coordination rules of Bill Section 1101, an individual's IRA deduction limit for a taxable year would be reduced, dollar for dollar, by the amount of the individual's elective deferrals under a Code section 401(k) plan or tax sheltered annuity. If Bill Section 1101 becomes law, it will eliminate contributions by a minister or lay worker to an IRA if such individual contributes $2,000 to a Church retirement income account.

Bill Section 1101 would permit employees participating in Code section 401(k) qualified plans without a Code section 401(k) feature to continue to make full contributions to IRAs, while ministers and lay workers who provide for their own retirement benefits through retirement income accounts would not be permitted to make full IRA contributions. Ministers and lay workers who contribute to retirement income accounts should not be put in a worse position than employees who participate in traditional qualified plans.

The House Report indicates that the IRA coordination rules contained in Bill Section 1101 are needed because IRA utilization is greatest among upper-income taxpayers who would generally have saved for retirement without regard to tax incentives. House Report, at 683. A 1983 survey of 12 main line denominations conducted by the National Council of Churches determined that the average compensation of ministers was $20,790 in 1982, a figure that includes salary, life insurance, medical and surgical benefits, housing and utilities. Although figures are not available, the Church Alliance believes the average compensation paid to Church lay workers is less than that paid to ministers. Ministers and lay workers require the added tax incentive that IRAs provide in order to adequately provide for their retirement. Thus, the application of the IRA coordination rules to Church retirement income accounts is inappropriate and inconsistent with the rationale expressed in the House Report.

Bill Section 1101 would make it difficult for ministers and lay workers to obtain retirement benefits at a level commensurate with employees in the private sector. The Church Alliance, therefore, strongly urges the Senate Finance Committee to allow ministers and lay workers to contribute in full to both IRAs and Church retirement income accounts.

D. Bill Sections 1113 and 1151 - Imposition of Anti-Discrimination Rules on Church Organizations.

Bill Section 1113 would extend the anti-discrimination rules currently applicable to qualified plans to employer contributions made under tax sheltered annuity programs. Some or all of these anti-discrimination rules currently apply to the Code section 401(a) qualified plans adopted by some Churches. The House of Representatives recognized the difficulty Churches would face under the qualified plan anti-discrimination rules because Bill Section 1113 contains an exception from these rules for retirement income accounts maintained by Churches and "qualified church-controlled organizations" described in Code section 3121(w). Churches that have adopted Code section 401(a) qualified plans already face this same difficulty.

The House Report notes that under the Code section 3121(w) exception, the anti-discrimination rules contained in Bill Section 1113 generally will not apply to the typical seminary, religious retreat center, church burial society or to Church-run orphanages or retirement homes. House Report, at 716. However, the House Report specifically provides that the exception from the anti-discrimination rules will not be available to Church-run universities (other than religious seminaries) and hospitals unless certain onerous requirements contained in Code section 3121(w) are met.[4] Id.

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[4] The reference to Code Section 3121(w) organizations means that the anti-discrimination rules of Bill Section 1113 would apply to a Church

[Footnote cont'd]

The imposition of anti-discrimination rules under Bill Section 1113 on the retirement programs of Church universities and hospitals totally ignores church boundaries that were recognized by the Congress in the benefit plan area in the MPPA in 1980. There Congress specifically addressed the church boundary issue and concluded that benefit programs sponsored by organizations that are controlled by or associated with Churches are "church plans" under Code section 414(e). Thus, Code section 414(e), and not Code section 3121(w), is the proper basis for an exception to the anti-discrimination rules of Bill Section 1113.

Bill Section 1151 would extend even more complex anti-discrimination rules to tax-favored welfare benefit programs. No exemption for welfare benefit programs maintained by either a Church or a Church ministry organization is provided under this provision.

Imposition of anti-discrimination rules on the Code section 401(a) qualified plans adopted by some Churches, imposition of the administratively complex and costly anti-discrimination rules of Bill Section 1113 on some

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[Footnote cont'd from previous page]

ministry organization if such organization (1) offers goods, services or facilities for sale (other than on an incidental basis to the general public), other than goods, services or facilities that are sold at a nominal charge which is substantially less than the cost of providing such goods, services or facilities, and (2) normally receives more than 25% of its support from either governmental sources or receipts from admissions, sales of merchandise, performance of services or furnishing of facilities in activities that are not unrelated trades or businesses, or from a combination of both.

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Church ministry organizations, and imposition of even more complex anti-discrimination rules on the welfare benefit programs of all Churches and Church ministry organizations under Bill Section 1151 ignores the fact that Churches and their ministry organizations are vastly different from for-profit employers. The benefit programs of Churches are established in a denominational environment without the self-interested motivation that is thought to exist in a for-profit enterprise. The light in which Churches and their ministry organizations operate, coupled with the commitment of such organizations to the high standards of conduct inherent in their respective faiths and beliefs, limit discrimination.

Further, Bill Section 1151's imposition of anti-discrimination rules that are designed for for-profit employers on Churches and their ministry organizations will increase the administrative burden and cost of providing welfare benefits to ministers and lay workers. Although Bill Section 1151's anti-discrimination rules would require Churches to provide additional welfare benefits to their ministers or lay workers, many of these individuals may not need or want additional benefits. Most Churches and Church ministry organizations have only a few professional or lifetime ministerial employees on their staffs, while other employees are frequently in the work force on a transient basis as second earners. Frequently such individuals work for a Church or a Church ministry organization out of a desire to help the Church fulfill its mission in the world rather than with a view towards maximizing compensation or benefits. Many of these same Churches and Church ministry organizations often operate on budgets that are never certain of fulfillment, due to the fact that their source of fulfillment is the congregational offering. Thus, the additional and high costs resulting from the imposition of anti-discrimination rules may operate to reduce the benefits currently available to ministers and lay workers, or, alternatively, reduce the missions and ministries such persons perform on behalf of Churches and Church ministry organizations. This extra cost would be borne by the Church in an environment in which charitable contributions to Churches are already expected to decrease due to tax rate reductions.

The anti-discrimination rules applicable to qualified plans were enacted in 1942 in response to demonstrated instances of abuse. In that same year, tax sheltered annuities were introduced into the Code, and no anti-discrimination rules were imposed on tax sheltered annuity programs at that time. The imposition of administratively complex and costly anti-discrimination rules on the retirement programs of Church or Church ministry organizations, whether Code section 401(a) qualified plans or Code section 403(b)(9) retirement income accounts, is inappropriate and unwarranted in the absence of evidence of abuse, and the Church Alliance does not believe such abuse exists. Unless Congress determines that there is a demonstrated need to impose anti-discrimination rules on Churches, and the House of Representatives did not as to most Churches and ministry organizations under Bill Section 1113, the Church Alliance submits that Churches and all ministry organizations within their boundaries (as such boundaries are established in Code section 414(e)) should be exempted from anti-discrimination rules imposed on retirement and welfare benefit programs generally.

E. Bill Section 1104 - Limitation of Church Unfunded, Supplemental Retirement Programs.

Bill Section 1104 would substantially inhibit, if not eliminate, the ability of Churches and their ministry organizations to provide supplemental unfunded retirement benefits for ministers and lay workers. Although the House Report describes Bill Section 1104 as a "relief" provision for tax-exempt employers (House Report, at 700), Bill Section 1104 in fact "harms" rather than "relieves" Churches and their ministry organizations. The Church Alliance submits that the Congress should do for Churches and Church ministry organizations what it did for for-profit employers in 1978. In that year, the potential impact of proposed Treas. Reg. § 1.61-16 was eliminated for for-profit employers. The 1978 action by Congress insured that for-profit employers may provide unfunded supplemental retirement benefits for management employees virtually without limit.

The House Report suggests that Bill Section 1104 is needed because limits must be placed on the amount of compensation that may be deferred under unfunded deferred compensation arrangements sponsored by nongovernmental tax-exempt employers. House Report, at 700. The House Report provides: "The usual tension between an employee's desire to defer tax on compensation and the employer's desire to obtain a current deduction for compensation paid is not present" in the tax-exempt employer setting. Id. In situations where many for-profit employers operate in a "tax-free" world due to substantial tax benefits even though they are profitable entities, no "tension" can exist. In addition, this so-called "tension" between an employee's desire to defer tax and an employer's desire to obtain a current deduction becomes totally illusory when one considers the extent to which unfunded supplemental benefit programs have been implemented by for-profit employers throughout this country.

It is ludicrous under any theory for the Congress to limit severely the provision of supplemental unfunded deferred compensation benefits by Churches and their ministry organizations while openly sanctioning the virtually unlimited provision of such benefits by for-profit employers. The Church Alliance, therefore, urges the Senate Finance Committee to reject the imposition of limits on the use of unfunded supplemental retirement programs by Churches and their ministry organizations.

F. Bill Section 1135 - Deferred Annuities Available Only to Natural Persons.

Bill Section 1135 provides that if any annuity contract is held by a person who is not a natural person, the income on the contract will be treated as ordinary income received or accrued by the owner of the contract. This rule does not apply to annuity contracts which are held under a qualified plan described in Code section 401(a) or 403(a) or under an individual retirement plan. No such exception is provided for Code section 403(b)(9) retirement income accounts. The Church Alliance understands that the failure to include retirement income accounts in the exception provided for qualified plans may have been inadvertant. The following statement in the House Report supports that view: "The provision does not apply to any annuity contract that is . . . held under a qualified plan (sec. 401(a) or (403(a)), as a tax-sheltered annuity (sec. 403(b)) or under an IRA . . . ." House Report, at 704.

If such failure was not inadvertant, then the Church Alliance submits that equity and fairness demand that any exception from Bill Section 1135's rules granted to qualified plans should also be extended to Church retirement income accounts. The Church Alliance, therefore, urges the Senate Finance Committee to correct this inequity if it includes a provision similar to Bill Section 1135 in its own tax reform bill.

G. Bill Section 144 - Elimination of Revenue Ruling 83-3.

Bill Section 144 would overturn the impact of Revenue Ruling 83-3, 1983-1 C.B. 72, and allow ministers and military personnel to continue to be able to deduct in full mortgage interest and taxes attributable to their residences. The Church Alliance applauds this relief provision in H.R. 3838, and submits that the Senate Finance Committee should extend the same relief to ministers as was extended by the Members of the House of Representatives.

H. Bill Section 1122 - Elimination of Constructive Receipt Issue for Retirement Income Accounts.

Bill Section 1122 would give tax sheltered annuities, and, thus, Church retirement income accounts, parity with qualified plans in the area of constructive receipt of retirement benefits by making it clear that ministers and lay workers covered by such accounts are not taxed on the benefits provided through such accounts until such benefits are actually received. The Church Alliance heartily supports Bill Section 1122 and urges the Senate Finance Committee to ensure that its own tax reform bill contains the same proposal.

I. Bill Section 1585(c) - Window Period for Electing Social Security Coverage.

Bill Section 1585(c) proposes to allow a "window" period that would give Churches and ministry organizations a one-time opportunity to revoke elections made under Code section 3121(w). These Code section 3121(w) elections excluded services performed by lay workers from the definition of "employment" for Social Security purposes, thereby subjecting these lay workers to the Social Security tax imposed on self-employed individuals. The Church Alliance commends and supports the "window" provided in Bill Section 1585(c), but believes there is also need for a new "window" period for individual minister elections.

Under Code section 1402(e), a minister may file an application for exemption from Social Security tax with respect to services performed in his religious capacity. Once filed, the election is binding for all taxable years and may not be revoked.

When ministers first begin their ministry they are at the lowest point on a salary scale that rarely, if ever, reaches significant amounts, as demonstrated earlier by the $20,790 total average compensation earned by ministers in 1982. A young, underpaid minister who is in need of funds to put food on his family's table and clothes on their backs often will elect to forgo Social Security benefits, which are many years away, for a few extra dollars which are available immediately. As a financial matter, such an election may be ill-advised in the long term. In the short term, however, the young minister may believe that no other choice exists.

In recognition of this problem, the Congress has in the past permitted ministers who elected not to participate in Social Security to change that decision by offering them a "window" period during which they may make a subsequent irrevocable election to be included in Social Security. Such an opportunity was afforded under Section 316 of the Social Security Amendments Act of 1977, thereby giving ministers a one-time chance to elect to participate in Social Security.

To some extent, an additional "window" period for minister elections is even more pressing than the one provided for lay workers under Bill Section 1585(c). Lay workers of Churches that made elections under Code section 3121(w) are at least covered by Social Security under the self-employment provisions, while ministers who made elections under Code section 1402(e) are completely excluded from Social Security coverage. The Church Alliance, therefore, urges the Senate Finance Committee to include a Social Security "window" period in its own tax reform bill so that both lay workers of Churches that made Code section 3121(w) elections and ministers desiring Social Security benefit coverage may obtain such coverage.

VI. ADDITIONAL CHURCH ALLIANCE PROPOSALS FOR TAX REFORM

Two other tax reform issues of vital concern to the Church Alliance and its members were not addressed in H.R. 3838. As the following discussion illustrates, enactment of provisions to address the problems described below would greatly enhance the fairness of the federal income tax system. The Church Alliance, therefore, requests the Senate Finance Committee to include provisions dealing with the following issues in its own tax reform bill.

A. Tax Free Receipt of Death Benefit Proceeds.

Some Church pension boards currently maintain self-funded employee death benefit programs for their ministers and lay workers, and in most cases have done so for many years. Pursuant to long-standing case law (and at least one well-known Internal Revenue Service ruling) the beneficiaries of deceased ministers and lay workers have properly treated benefits paid under such programs as life insurance proceeds excluded from income under Code section 101(a) for federal income tax purposes. However, Code section 7702, as added by the Deficit Reduction Act of 1984 for the purpose of controlling the use of investment-oriented commercial life insurance contracts, could be interpreted to restrict the exclusion of insurance proceeds to benefits paid pursuant to an arrangement that has the status of an "insurance contract" under state law.

Unless Code section 7702 is clarified, the dependants of deceased ministers and employees who are covered under Church self-funded employee death benefit programs could be required to include death benefits that they receive under a Church self-funded death benefit program in taxable income. In addition, the programs themselves will be subject to administrative uncertainty with respect to the proper tax treatment of the payments made.

Fairness, simplicity and overall equity will be better served by amending the Code to state affirmatively that amounts received by beneficiaries under self-funded death benefit programs sponsored by a Church or a Church ministry organization will be excluded from the recipient's income as long as such programs meet the following long-established criteria: (1) risk shifting and risk distribution, (2) actuarial soundness, and (3) provision for the payment of a "definitely determinable death benefit." The Church Alliance urges the Senate Finance Committee to clarify Code section 7702 so that amounts received by a beneficiary under a death benefit plan sponsored by a Church or a Church ministry organization will continue to be exempt from income taxation.

B. Social Security Amendment to Aid Lay Workers.

Between 1950 and 1984, participation in Social Security by Code section 501(c)(3) tax-exempt organizations was voluntary. During the 1950s and 1960s almost all Code section 501(c)(3) organizations elected to participate in Social Security. However, in the late 1970s, a few tax-exempt employers terminated their participation in Social Security and installed retirement programs (hereafter referred to as "Replacement Programs") that were intended to provide employees with "lost" Social Security benefits, but at hopefully less cost to the employer. These terminations took an increasing number of employees out of the Social Security system and led, by virtue of the then existing Social Security benefit formula, to Social Security "windfalls" for employees who had employment covered by Social Security and the benefit of a Replacement Program.

Congress reacted in part to these Replacement Programs in the Social Security Amendments Act of 1983 by implementing an anti-windfall provision that modified the Social Security benefit formula for employees of tax-exempt employers in certain cases. Although the anti-windfall provision would only seem to be properly applicable to employees whose employers adopted Replacement Programs, the provision in fact offsets the Social Security benefit that would otherwise be due to employees of tax-exempt employers by as much as half of any retirement benefits earned for service not constituting "employment" under the Social Security Act, even if the retirement benefits in question were not paid under a Replacement Program.

Churches and their ministry organizations have a few lay workers who are subject to the anti-windfall provision even though their employers never adopted a Replacement Program. The Church Alliance believes that it would be unfair to apply the anti-windfall provision to these lay workers, thereby confiscating part of their private pension program by using it to offset the Social Security benefit they otherwise will earn. Although the number of lay workers who are potentially affected by the anti-windfall provision is small, its effect on those few individuals could be extremely harsh. A married couple could face a loss of benefits under the provision that has a present value at age 65 equal to $25,000.

The Church Alliance has brought this technical oversight to the attention of Dr. Robert Myers, former Chairperson of the President's Commission on Social Security (the "Commission"). The recommendations of the Commission led to the Social Security Amendments Act of 1983. The Church Alliance understands that Dr. Myers agrees that the anti-windfall provision was intended to apply only to employees whose employers terminated Social Security participation and installed a Replacement Program.

The Church Alliance urges Congress to clarify the Social Security Act and make it clear that the anti-windfall provision in question does not apply to lay workers who chose not to participate in Social Security for reasons other than their employer's decision to terminate Social Security participation and install a Replacement Program.

VII. SUMMARY AND CONCLUSION

Certain provisions of H.R. 3838 would tax Churches and their ministry organizations, ignore the historic ecclesiastical boundaries of the main line religious denominations of this country in several respects and impose unnecessary, complex and substantial administrative costs and burdens on Churches, Church pension boards and ministry organizations. Such provisons would effectively decrease the levels of retirement and welfare benefits that are provided to ministers and lay workers and force Churches and their ministry organizations to redirect their limited funds away from many mission and benevolency projects. This increased burden on Churches would be exacerbated by the likelihood that congregational offerings will diminish due to decreases in the tax rate structure.

The historic boundaries of the Church in this country should be honored and left intact for all purposes, especially for tax purposes. The constitutional considerations discussed above demand that Churches and their ministry organizations be treated with greater sensitivity than for-profit employers, and certainly should be put in no worse position than for-profit employers in terms of providing different types and levels of retirement and welfare benefit programs.

Although the Church Alliance does not have the revenue estimating capabilities available to the Department of the Treasury and the Joint Committee on Internal Revenue Taxation, the Church Alliance believes that any additional revenue generated by the provisions discussed herein, as applied to Churches and their ministry organizations, would only represent an asterisk on anyone's revenue table. Therefore, the Church Alliance steadfastly urges the Senate Finance Committee to ensure that:

(1) Churches and all organizations within their historic boundaries will be exempt from the taxes proposed in Bill Sections 1012 and 311 and the harmful retirement and welfare benefit restrictions contained in Bill Sections 1102, 1101, 1113, 1151, 1104 and 1135;

(2) The Social Security Act will be amended to (a) allow certain Churches and ministers a window period within which they may elect to participate in the Social Security System and (b) correct the unintentional inclusion of lay workers in a punitive benefit calculation provision enacted as part of the 1983 Social Security reform;

(3) Language identical to Bill Sections 144 and 1122 will be included in the Senate's tax reform bill so that (a) ministers may continue to deduct all of their residential property taxes and mortgage interest payments and (b) benefits provided through retirement income accounts will not be taxed until actually received; and

(4) Code section 7702 will be clarified so that death benefits paid by or through Church pension boards will clearly be excludable from income by the recipient.

FEB 1 1986

Office of the Mayor • Dale Danks, Jr., Mayor

219 S. President Street • P.O. Box 17 • Jackson, Mississippi 39205 • (601) 960-1084

MAYOR
DALE DANKS, JR.

JACKSON CITY COUNCIL
WARD 1
Derwood Boyles
WARD 2
Louis E. Armstrong
WARD 3
Doris Palmer Smith
WARD 4
Marcia Weaver
WARD 5
E C Foster,
President
WARD 6
Luther Roan, Jr.
WARD 7
Margaret Carroll Barrett,
Vice President

February 6, 1986

Mr. Bill Diefenderfer
Chief of Staff, Senate Finance Committee
Room 219, Dirkson Senate Office Building
Washington, D.C. 20515

Dear Mr. Diefenderfer:

I just wanted to take this chance to let you know how much I appreciated the opportunity to meet with you when I was in Washington on Wednesday, January 22nd.

I appreciate your attention to the hardships which will be faced by municipalities and other local governments under the Gramm-Rudman Act and the proposed Tax Reform Act.

Please find enclosed herein a copy of my remarks for the record for the Senate Finance Committee. I appreciate the opportunity you have afforded me to have these remarks presented to the Committee.

I sincerely appreciate any help you can give us in this regard and, if there is anything I can do to assist your efforts, please call upon me.

Sincerely,

Dale

Dale Danks, Jr.
Mayor

DD/dah

Enclosure

Bob
1) Put Testimony in Record
2) write to Mayor and · My signature telling him His testimony is placed in Record
B

REMARKS CONCERNING TAX REFORM ACT OF 1985

My name is Dale Danks, Jr., and I am Mayor of the City of Jackson, Mississippi. I appreciate the opportunity to make these remarks concerning the effect of the proposed Tax Reform Act of 1985 upon municipalities the size of Jackson and I would hope that the Senate would take appropriate steps to insure that the benefits derived from the Tax Reform Act are not allowed to overshadow the disastrous effects of some of its provisions upon municipalities.

I would like to direct the attention of the Committee to three areas in which the City of Jackson and other municipalities will be detrimentally affected by the Tax Reform Act.

First, the provisions which restrict the amount of investment earnings which a municipality may accumulate and apply toward a bond issue project will have the ultimate effect of aiding the Federal Treasury at the expense of local taxing units. If a municipality is not able to invest general obligation bond proceeds at the highest possible interest rate without being required to pass through the benefits of these rates, then it stands to reason that the municipality must either issue more bonds in order to cover the desired projects or there must be fewer projects built for the benefit of the municipality's citizens. Since debt service on larger general obligation bond issues must be paid through taxes imposed upon local citizens, the effect of the proposed Tax Reform Act is simply to transfer tax liability from one level of government down to the municipal level. On behalf of myself and other mayors, I believe it is manifestly unfair for citizens to be led to believe that they will benefit as a result of this act when in fact only the agency which their tax dollars are filtered through will be affected.

A concrete example of the problem can be demonstrated with the general obligation bond issue the City of Jackson sold in 1983. Twenty-eight million dollars worth of bonds were sold to finance improvements for the street system, the drainage system, the parks and recreation system and the fire department. As a result of prudent investments, over five million dollars in interest earnings were realized and utilized to increase the scope and nature of improvements that ordinarily could have been done with the same dollar amount. Under the terms of the present Tax Reform Bill, we estimate that we would suffer a loss of virtually all of the investment earnings. The net effect of this will be that fewer miles of streets can be improved, fewer areas affected by erosion and water damage can be corrected, and fewer neighborhoods will have the benefit of improved parks and playground facilities.

A second and equally ominous ramification of the proposed Tax Reform Act is the detrimental effect the Act will have on the issuance of industrial development bonds. For a number of years the City of Jackson, as most other municipalities, has utilized industrial development bonds for the encouragement of industry and commerce in the metropolitan area. As in most parts of the country, these bonds have been issued only for valid industrial purposes, not for the promulgation of fast food restaurants or other endeavors of marginal economic benefit. It is not sufficient to say that if the industrial development bond inducement is removed from all municipalities, then all municipalities will have an equal chance of securing the industrial development that does occur. It has been the experience of the City of Jackson that these bonds are essential not only in attracting industry from outside the community but in allowing local industry to expand on terms which might otherwise have been prohibited by the prevailing interest rates in the market. Removal of industrial development bonds as an active tool to encourage industrial development in the nation's cities will decrease the chances for activities across the country which promote employment and stimulation of the local economy.

Finally, the third serious problem which faces the City of Jackson (and all other cities) as a result of the proposed tax legislation is the fact that while the legislation is in its current state of uncertainty, it is impossible to market bonds of any type. The City of Jackson presently has an urgent need for renovation and expansion of its water system. We need to improve and expand our sanitary sewer facilities. We have streets which need widening and natural drainage basins which must be improved in order to protect the homes and property of our citizens. We presently have, in various stages of adoption, three separate bond issues: one general obligation issue for the improvement of streets, drainage, and park facilities; one sewer revenue issue for the improvement and expansion of our sewer system; and one water revenue issue, for the improvement and rehabilitation of our existing system and the construction of a new water treatment plant. All of these improvements are essential if the City of Jackson is to continue to grow and prosper. There is nothing out of the ordinary or convoluted about any of these issues as they now exist. But until the Congress issues some sort of definitive binding statement to the effect that if the present tax legislation is in fact passed, the effective date will not be until the date of signing or, hopefully, the beginning of next year, it is impossible to obtain an opinion of bond counsel in the present state of events which will allow the marketing of any bonds. Therefore, essential City improvements are being neglected because of our inability to obtain even conventional financing.

Thank you on behalf of the City of Jackson and other municipalities for your attention. Again I would request that as soon as possible you give immediate attention to our request that you establish a firm effective date for the legislation if it is passed and then take into consideration our other comments in determining the final content of the Act.

TESTIMONY OF
THE COALITION OF SERVICE INDUSTRIES
SUBMITTED TO
THE SENATE FINANCE COMMITTEE
FEBRUARY, 1986

The Effects of Proposed Tax Reforms on the International Competitiveness of U.S. Industries

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The Coalition of Service Industries appreciates this opportunity to comment on the effects of proposed tax reforms on the international competitiveness of U.S. service businesses.

We find certain provisions of the tax reform bill reported by the House of Representatives to be particularly injurious to American service industries with operations abroad.

The service sector is the backbone of the U.S. economy and has consistently reported a surplus in the balance of payments, keeping our national trade deficit from becoming even worse. The foreign tax provisions contained in the House Ways and Means Committee bill represent a radical change in the historical U.S. tax treatment of foriegn income, have not been the subject of any hearings, discriminate against U.S.-owned international service businesses, and have a dramatic detrimental impact on the ability of such businesses to compete in foreign markets.

I would like to just briefly go through some of the major provisions we oppose.

The foreign tax provisions of the bill represent a radical reversal of generations of federal tax policy, which have never been the subject of Congressional hearings. There has been no evaluation of these proposals for their technical correctness or for their anticompetitive trade implications on U.S. service companies. Further, these options inexplicably discriminate against service firms. Because service firms tend to follow their customers overseas, hampering their expansion will have an adverse ripple effect throughout the U.S. economy. For instance, it will curtail the foreign lending capabilities of U.S. banks needed to finance U.S. exports or the ability of the U.S. to maintain a viable merchant fleet.

These changes could not come at a more inappropriate time. The 1984 Trade and Tariff Act mandated parity of treatment between the services and goods sectors in order to enhance the export of services. Now, our government's effort to organize trade in services through the GATT will be undermined by this tax counterpolicy.

The international service business follows its clients overseas to service them. For example, a manufacturing company opening a new plant in a foreign country will require local insurance services and will look first to its U.S. broker and insurer to meet those needs. In this fashion, the U.S. broker and insurer seek to retain the totality of their client's worldwide business.

Foreign laws and regulations generally restrict trade in services and require service businesses to make a direct investment in the country in which they wish to offer their services. This is the reason, therefore, that international service businesses often have many more foreign subsidiaries than manufacturing firms. This pattern of following one's clients overseas indicates that service businesses do not have the flexibility to pick target countries purely because they may be low tax. In fact, taxes usually are not a consideration at all.

The foreign tax provisions of this bill are far reaching, especially as they affect Subpart F, the foreign tax credit, the allocation and apportionment of deductions for the foreign tax credit computation, and the source of income rules. These provisions have been the pillars of the U.S. tax structure governing the foreign investment and activities of U.S. tax payers. They were designed in part with a view to keeping U.S. taxpayers competitive in the international marketplace. Inexplicably, these provisions make changes that are detrimental to just one segment of the economy -- international service businesses. Quite simply, these provisions will make it impossible for some companies to operate in foreign countries.

The Subpart F provision, by including certain active business income, amounts to a repeal of deferral for many U.S.-owned foreign banking, financial, shipping and insurance corporations. Congress has repeatedly upheld the policy that active business income should not be subject to current taxation until actually repatriated to the United States. All industrialized countries recognize deferral for overseas active business income. Without it, U.S. companies will be less competitive than their foreign counterparts. Without question this repeal of deferral discriminates against a significant sector of the service economy.

But if repeal of deferral is death for many businesses, the separate foreign tax credit limitation for low-tax/high tax income of service companies is worse than death. Any departure from the overall limitation, well established in existing law, will result in the inability of U.S. service companies to "average" their highly taxed foreign income against lightly-taxed foreign income. This proposal will impair the ability of U.S. companies to compete in those countries imposing a high rate of corporate income tax. In considering alternatives to the overall limitation, the staff apparently rejected the "per-country" method as too complex. The "low-tax" income option in effect adds "per-item" complexity to "per-country" and the result must be complexity squared. Congress decided wisely the last time around that only the overall limitation with retention of deferral makes sense in an internationally, interconnected, and intercompetitive world.

In another section of the bill, the proposed modification to the expense allocations rules overturns decisions arrived at after 12 years of Treasury Department and industry negotiations of a complex issue. By generally increasing expenses allocated to foreign source income, coupled with the proposed changes to Subpart F and "low-tax" basket limitations, the value of the foreign tax credit will be severely cutback resulting in U.S. corporations being burdened by double taxation.

Further, by changing the source rules in significant respects, the Committee is creating many new situations of potential double taxation. The Committee should adopt an expanded version of the President's proposal to eliminate double taxation in the area where construction services are rendered in the U.S., but the country that uses or consumes them taxes its payments at the source of payment. An election to deduct or use a source rule similar to the rule applied to royalty income is recommended for an expended category of highly technical services rendered in the U.S. but used and taxed overseas. The U.S.' failure to do so will just encourage those operations eventually to move overseas.

Two of the Committee's options are specifically anti-export. Instead of reducing the FSC benefit after only one year of availability, the Committee should expand the FSC to include additional services, consistent with Congress' overall trade policy. The proposal to reduce the current $80,000 exclusion of income earned abroad to $50,000 and include the excluded income in the individual minimum tax base is contrary to trade policy which should be designed to encourage Americans to make the sacrifices attendant with employment in a foreign country.

The Coalition has carefully studied this legislation and it is our conclusion that, if it is the policy of this government that U.S. businesses remain competitive abroad, the foreign tax provisions must be removed.

Service businesses already face tremendous obstacles to fair competition in foreign markets. Imposition of yet another barrier in the form of burdensome tax laws -- a barrier erected by the U.S. government -- will throttle the momentum of the United States service sector abroad and render uncompetitive that one positive account in an otherwise dismal balance of trade.

COALITION TO REDUCE
HIGH EFFECTIVE TAX RATES
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STATEMENT OF

THE COALITION TO REDUCE HIGH EFFECTIVE TAX RATES

SUBMITTED TO

THE COMMITTEE ON FINANCE

UNITED STATES SENATE

February 20, 1986

"Hearings on Tax Reform"

Introduction

The Coalition to Reduce High Effective Tax Rates submits this statement to the Committee to express the strong support of our member companies and associations for a fundamental restructuring of the income tax which substantially reduces high effective tax rates.

The top rates proposed by H.R. 3838 move in the right direction, but further reductions should be included in final legislation.

Specifically, we urge that tax rate schedules for corporations and for non-corporate businesses be adopted using top rates which are no higher than the 33% and 35% rates proposed by the President.

We urge the Committee to take prompt action this spring to prepare legislation which achieves these objectives.

I. Recommendations

The Coalition makes three specific recommendations concerning rate reductions in a major tax reform package.

1. The President's tax rate reductions should be included in the Committee's bill. A 33% maximum corporate rate should be enacted. Similarly, the President's proposal for a 35% maximum rate on non-corporate businesses should be enacted. The proposals for maximum rates of 36% and 38% respectively in H.R. 3838 do not go far enough.

2. Reductions in tax rates should be implemented all at once. The allure of a gradual phase-in of tax rate reductions should be resisted, in order to minimize the possibility that such reductions could be halted a year or two after enactment.

3. The Committee should make the effective date of rate reductions coincide with the dates for other changes. There should be no delay in implementing this fundamental benefit of tax reform.

II. The Members Of The Coalition

The Coalition to Reduce High Effective Tax Rates was formed in June 1983 by associations and corporations which shared mutual concerns about --

1. the limited awareness by the public, by policymakers and by the press that many businesses pay income taxes at high effective rates,
2. the near-term possibility that high effective tax rate businesses would be hit by allegedly "equitable" tax increases in the form of a surtax or other related devices that do not fully recognize the tax burdens already borne by such businesses, and
3. the need to substantially reduce the existing high nominal tax rates.

The members of the Coalition (a list is attached as the Appendix) include prominent *Fortune* 500 industrial companies and associations which represent a wide range of high growth medium-sized companies, small businesses, trucking companies, retailers, and wholesaler-distributor firms.

The Coalition has worked diligently since 1983 to create an awareness that a significant number of industries bear effective tax rates which are far higher than the 0% to 10% figures which receive prominent attention in the media and in congressional speeches.[1/] In fact, there are many companies and entire industries -- including apparel manufacturers, beverage companies, computer and office equipment manufacturers, food processors, instrument companies, retailers, tobacco companies, trucking companies, and wholesaler-distributors -- which pay income taxes at effective rates which are near or are well above 30%. Members of this Coalition are representative of such companies.

Coalition members are substantial taxpayers as measured in dollars, as well as in effective tax rates. For the three years from 1982 through 1984, corporate members of the Coalition and companies which are members of the associations which belong to the Coalition paid almost $15 billion in federal corporate income

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[1/] An effective income tax rate for a company is generally expressed as the ratio of actual taxes paid to the company's financial income. Many deductions, exemptions and credits have the effect of reducing the effective tax rate of a financially profitable company to a percentage which is less than the 46% maximum corporate rate. Coalition members' effective rates are significantly higher than the widely-held perception that all businesses pay federal income taxes at relatively low rates of 0% to 10%.

taxes. This was more than 10% of the total corporate tax receipts for that three-year period. Furthermore, they paid an additional $7 billion in employer's FICA taxes, plus an additional $13.7 billion in other federal, state and local taxes.

We are pleased that significantly more attention is now given to the fact that many companies and industries pay income taxes at high effective rates. This fact, coupled with an awareness of the gross inequities of a surtax applied to already high effective rates, has allowed the Coalition's attention to shift to fundamental tax restructuring which is based on substantial reductions in tax rates.

III. Benefits of Substantial Rate Reductions

The long-term benefits to the economy of substantial rate reductions have been given distressingly little consideration to date, in contrast to the attention provided to problems which are raised with regard to major elements of the President's total tax reform package. Three such benefits are discussed in items A, B, and C below.

A. Long-term Economic Benefit

The economy-wide benefit of substantial rate reductions will be to lighten the heavy hand of high tax rates on the millions of business and personal financial decisions which are made daily. The effect of a high tax rate may be so direct as to lead the individual/business manager to forego some activity because its benefit no longer outweighs the time, resources and taxes which it will cost. Or, more likely, a decision is made to lessen the tax bite on our work and investments by taking actions which otherwise do not make sense. "Tax shelters" for individuals and lease financing subsidaries for many corporations are rational, although economically questionable, responses to high tax rates. The inefficiencies of such tax-motivated transactions should be attacked directly by reducing high tax rates, as well as through the traditional "loophole closing" amendments.

Rate reductions are not a cure for all ills. But the effect on the overall economy -- namely, the loosening of the tax law's grip on efficient market-oriented decisions -- should be a priority objective for tax reform legislation in 1986.

B. Reducing The Value Of Specialized Tax Provisions

A high nominal tax rate places a substantial economic premuim on the enactment and retention of deductions for specific expenditures, of exemptions for various types of income and of credits for certain types of investments. Given the 46% corporate tax rate, the fervor with which a company or an entire industry supports the enactment of a new provision or the retention of an existing deduction, exemption or credit is rational economic behavior.

However, the diversions by businesses of their human and financial resources into enacting, implementing, administering and retaining the wide array of provisions which have arisen under high tax rates have created a substantial growth industry. It is certainly arguable that individual companies as well as the entire economy would be better served by redirecting such resources away from tax planning and back toward business activities.

A reduction in the top corporate rate to 33% would be an important first step toward this goal. While the long-term result cannot be forecast with certainty, such a reduction should reduce the willingness by owners and managers to expend resources for sophisticated tax planning and for tax legislative activity. Each deduction of $100 would save only $33 in taxes rather than $46. While the repeal or restriction of some portion of the existing list of deductions and credits would broaden the base to which the 33% rate was applicable, thereby tending to raise taxes for some companies, the 33% rate would lessen the reward for seeking to remove certain amounts from the base.

C. Reducing The Existing Preference For Debt Financing Over New Equity Capital

The income tax allows a corporation to deduct its interest expense for debt, whether in the form of publicly traded bonds or bank loans, while imposing a double tax on the dividends which are paid to the equity investors. The result is to create a clear economic preference by the corporation for debt rather than equity, assuming other factors do not affect the decision.

For example, the corporation which is considered by lenders and equity markets alike to be a quality risk could choose to seek new capital either through additional debt or through a new offering of stock. Assume interest costs would be 10% a year, while dividend payouts would be about 7% of new equity proceeds. Interest is deductible, so the after-tax cost of debt to the corporation would be 5.4% per year. The non-deductible dividends would cost a full 7% in after-tax dollars.

A reduction in the corporate tax rate to 33% would be an efficient means for lessening the tax-induced preference for debt financing for two reasons. First, when the tax rate is reduced from 46% to 33%, the after-tax cost of interest payments rises from 54 cents on the dollar to 67 cents on the dollar. At the same time, the corporation's after-tax earnings from which dividends are paid are increased as the tax rate falls. To the extent that the corporate tax is actually a tax on profits which the shareholders own, a reduction in that tax should allow for a higher return to shareholders over time.

Thus, the gap between the higher cost of equity and the lower cost of debt is narrowed by the simple act of a substantial reduction of the tax rate. Arguably, this could lead to either lower interest rates (if demand for debt were lessened) or increased dividends (as after-tax earnings increased) or some mix of the two, depending upon one's view of economic theories. But at least one result should be clear. A substantial rate reduction can do much to lessen the tax-induced preference for debt financing.

IV. Conclusion

Reductions in tax rates will result in a number of long-term benefits for the efficiency with which our economy functions and the rate at which it grows. Because such results are less subject to quantification than the effects of each specific element of proposed tax reforms, rate reduction is not generally given the attention which it deserves.

The Coalition to Reduce High Effective Rates is committed to supporting a major tax reform effort based on the expressed intention of the President and members of Congress to reduce top tax rates to 33% for corporations and to 35% for non-corporate businesses, along with other adjustments to lower rates. We urge the Committee to include these rate schedules as the centerpiece of proposed legislation.

Appendix--Membership Of The Coalition To Reduce High Effective Tax Rates

American Business Conference

American Can Company

American Trucking Associations

Armstrong World Industries

Beatrice Companies, Inc.

Chesebrough-Pond's Inc.

Dart & Kraft, Inc.

General Foods Corporation

General Mills Inc.

General Motors Corporation

IBM Corporation

Levi Strauss & Co.

National Association of Wholesaler-Distributors

National Federation of Independent Business

National Retail Merchants Association

The Pillsbury Company

The Procter & Gamble Manufacturing Company

R.J. Reynolds Industries, Inc.

3M Company

CBEMA

STATEMENT

OF THE

COMPUTER AND BUSINESS EQUIPMENT MANUFACTURERS ASSOCIATION

(CBEMA)

TO THE

SENATE COMMITTEE ON FINANCE

MARCH 10, 1986

Computer and Business Equipment Manufacturers Association 311 First Street, N.W., Suite 500, Washington, D.C. 20001 (202) 737-8888

CBEMA SENATE FINANCE COMMITTEE STATEMENT

TAX REFORM AND INTERNATIONAL COMPETITIVENESS

CBEMA believes that tax reform, if properly undertaken, can be a positive step in transforming our tax system to meet the increasingly high technology orientation of the U.S. economy. It can thus help CBEMA members in their efforts against international competition. Because of the high technology nature of their businesses, CBEMA members generally have effective tax rates higher than that of most U.S. industries under the present system. Studies by the Joint Tax Committee and by the publication Tax Notes consistently indicate that the computer industry has in the past few years had effective tax rates ranging from 40 to 60 percent higher than average corporate rates. This results because the computer business is research-intensive as well as capital-intensive. Moreover, the capital investments of the computer industry are largely in equipment and manufacturing facilities which rapidly become technologically obsolete.

Given the nature of its industry, CBEMA can support tax reform which would achieve the following goals:

- reduce corporate tax rates
- give top priority to R&D incentives
- provide substantial incentives for capital investments that apply to short-lived as well as long-lived assets; and

- recognize that the taxation of international as well as domestic operations affects the international competitiveness of U.S. companies.

Both the President's proposal and the House bill take some positive steps towards accomplishing these goals. However, if international competitiveness is to be strengthened for this industry, the Committee must modify these proposals in several respects.

Reduction in Corporate Rates

CBEMA applauds the efforts reflected in the President's proposals and the House bill to reduce corporate tax rates. The current high level of corporate rates together with a relatively narrow tax base has produced a system which yields widely differing effective rates of tax in different industries. In many ways it has worked to the disadvantage of the high technology sectors of the U.S. economy. The basic reform concept of closely scrutinizing incentive provisions, eliminating or reducing those that are outmoded or overly generous (while preserving those that continue to serve important economic purposes), and utilizing the revenue to reduce corporate rates is a positive step. It could hopefully lead to increased investment in industries like that of CBEMA members, which today are relatively highly taxed.

Priority Incentives for R&D

Notwithstanding the general movement toward a broader base, lower rate tax system, it is extremely important that tax reform permit the continuation of those tax incentives which are important to the future of our nation's economic activity and to our industry's industrial competitiveness worldwide. Primary among these is the R&D tax credit.

The R&D credit was enacted in 1981 and is currently scheduled to expire at the end of 1985. Several recent studies, including one by the Congressional Research Service, have concluded that the credit should be extended and indeed made permanent even in the context of broad base tax reform. The reasons for this conclusion are quite apparent. Most major foreign countries -- including Japan, Canada and West Germany -- have substantial R&D tax credits. Moreover, unlike virtually any other activity which might be encouraged through the Internal Revenue Code, the benefits of R&D investments are not captured fully by those taxpayers making the investments. Instead, the benefits quickly spread throughout the economy, improving the quality of life, worker productivity and our gross national product. These benefits from R&D, which accrue to the country generally but not to the party investing in R&D, make a compelling case for governmental policies to increase the level of R&D undertaken by the private sector.

The current R&D tax credit fulfills this vital policy need. A study by Martin Bailey and Robert Lawrence (of the Brookings Institution) and by Data Resources, Inc. concludes that the R&D tax credit has been successful in generating sufficiently substantial increases in R&D to justify the revenue cost of the credit. Under relatively conservative assumptions, the authors find that a permanent R&D tax credit would generate from $1.2 to $7.5 billion of annual GNP increases in 1986 and from $2.9 to $17.7 billion of GNP increases by 1991. The credit currently costs the Federal Government something less than $1.5 billion per year.

These increases in GNP resulting from the R&D credit apply whether or not the corporate tax rate is reduced by tax reform. Indeed, the Congressional Research Service points out that:

> The reduction of the tax rate, which is the trade-off for losing tax preferences, may not be very valuable in the case of R&D investments which are highly risky. The lower tax rate may increase potential return, but it also increases variability in return. Thus, the tax rate reductions may actually have a negative impact on R&D investments and justify a retention or increase in the subsidy [i.e., the R&D credit].
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> [Congressional Research Service, "The Tax Credit for Research and Development: An Analysis," January 25, 1985, at p. 41.]

The President has recognized the continuing need for incentives for R&D by proposing a three-year extension of the

R&D tax credit. The House bill also extends the credit for three years, but reduces the credit rate to 20 percent. CBEMA strongly believes that a three-year extension of the credit is insufficient. In the computer industry major R&D projects typically take longer than three years -- five to six years in many cases. Thus, if the credit is to have its full potential impact on R&D spending, it must be extended for a much longer period of time than three years. CBEMA believes the credit should be made a permanent part of the Internal Revenue Code.

The House bill reduction in the R&D credit rate from 25 to 20 percent should also be rejected. As the Congressional Research Service Study cited above indicates, unlike other credits the reduction in general tax rates does not mean the R&D credit rate can be reduced without reducing its incentive effect. If anything, the CRS Study concludes, the R&D credit rate should be increased if the corporate rate is reduced. The R&D credit represents in fact a modest effort (costing about $1.5 billion per year) to influence large amounts of spending (NSF estimates are that in 1985 about $50 billion was spent on commercial R&D). Yet, it is highly leveraged to have a significant impact on R&D and GNP. Any reduction in the credit from its current 25 percent level can only reduce this leveraged impact. The modest cost savings will clearly not outweigh the detrimental effect on R&D, GNP and the international competitiveness of U.S. companies.

Both the House bill and the President's proposal do not allow the R&D credit against the proposed corporate alternative minimum tax. While these proposals would lessen the effectiveness of the credit for many taxpayers, CBEMA does not oppose them. It does, however, oppose proposals which would disallow deductions for corporate R&D expenditures. Any corporate minimum tax proposal is intended to ensure that all profitable corporations pay some minimum level of taxes regardless of their use of various incentive deductions, exclusions or credits in the Code. In this context it is perhaps appropriate that the R&D tax credit, which is clearly intended as an incentive to private research, not be allowed to reduce a taxpayer's minimum tax. However, it is also clear that the deductions taken by taxpayers for R&D expenditures -- i.e., the salaries of R&D personnel, their supplies and other related costs -- should be currently allowed. This result should occur for the following reasons:

- R&D expenditures are required to be deducted for financial reporting purposes to shareholders and to the SEC. Consequently, no profitable corporation can pay taxes below any designated minimum effective tax rate (based on financial income) because of the deduction of R&D.
- The Internal Revenue Code provision permitting R&D to be deducted was enacted in 1954 to provide certainty and consistency of treatment, not to establish an incentive for R&D expenditures.
- In other major countries of the world R&D expenditures are deducted for both tax or financial accounting purposes.

- Disallowing R&D deductions under a minimum tax will cause a major tax increase to high technology companies which already pay relatively high effective rates of tax.
- More than any other single provision in tax reform, the treatment of R&D deductions as a tax preference under a corporate minimum tax will adversely affect the ability of CBEMA members to conduct R&D in the United States and compete effectively in world markets.

Investments in Short-Lived Equipment

Incentives for Investments

Prior to the enactment of the Accelerated Cost Recovery System (ACRS), most computer and other electronic office equipment was depreciated over a five-year period at a double declining balance rate. Similarly, the manufacturing equipment of computer and other high technology companies was depreciated over five years prior to 1981. This depreciation was roughly consistent with the depreciation for financial purposes of most major companies. Thus, the enactment of ACRS, which provided for five-year depreciation on a less than double-declining balance basis, provided little if any tax benefit to the equipment of CBEMA members. Indeed, in many cases the tax depreciation of this equipment under ACRS was slower than depreciation for financial accounting purposes.

At the same time, since its enactment in 1962, the investment tax credit has been a substantial incentive for new investments by CBEMA members and, even more importantly, by their customers. Computers and other high technology equipment of CBEMA members are primarily used by America's businesses. In recent years an increasing portion of America's business investment has been of high technology computing and other electronics equipment. Some estimates for 1983 indicate that over 40 percent of capital spending for new equipment during that period was invested in electronic automation equipment. By encouraging these investments, the investment credit has been a major policy instrument through which the tax code has increased the productivity and efficiency of U.S. businesses in all industries. Thus, CBEMA members are seriously concerned that the loss of the investment tax credit, particularly if undertaken precipitously, could have a significant adverse impact on U.S. capital investments in general and in high technology products in particular.

However, if the investment credit is to be repealed, it is vital that any tax reform package include a system of depreciation which (1) provides substantial incentives for investments in new plant and equipment and (2) like the investment credit but unlike ACRS, benefits short-lived as well as long-lived assets. The Administration's Capital Cost Recovery System (CCRS) in principle accomplishes both of these goals. The House bill's ADR system fails to accomplish the first goal. Under the President's proposed system, computers and other electronic office equipment, for example, are included in Class 2 and are depreciated at a constant 44 percent declining balance rate. This classification recognizes the existence of actual short economic lives for this equipment and applies a rate of depreciation which does provide significant incentives. It partially, although not completely, offsets the impact of eliminating the investment tax credit. The House bill also recognizes the short lives of computers, depreciating them over five years, but uses a significantly lower declining balance depreciation rate. We believe that the Finance Committee should attempt to accelerate these depreciation schedules further to prevent a significant slowdown in the rate at which taxpayers make new investments in productivity enhancing equipment and facilities.

In addition, while the House bill generally provides a proper classification for computers and electronic manufacturing equipment, a serious effort needs to be undertaken in the Senate to refine its classification of telecommunications equipment. Most telecommunications equipment currently being placed in service in the newly deregulated telecommunications industry is virtually identical to computers. Yet, the House bill places only some of that equipment in Class 2 with computers and other high tech equipment. The clear convergence of the computer and telecommunications industries and of the technologies underlying their products strongly suggests that any dissimilar treatment is inappropriate.

The House bill proposes that a new Treasury office be established to study actual depreciation rates and, based upon the study, to make reclassifications of assets -- like telecommunications equipment -- for tax depreciation purposes. While this procedure is necessary, it could take a substantial time (*e.g.*, three to five years) after tax reform is enacted before assets are in fact reclassified. In the meantime, the inappropriate treatment would be applied.

Given this delay, where the discrepancies between the classifications set forth in the House bill and actual economic depreciation are apparent, we believe Congress should not merely delegate reclassification authority to the Treasury Department. Rather, Congress should itself act on the best evidence available and establish its own generalized classification system. Treasury could then make further adjustments through its studies where appropriate.

Short-Lived Equipment and Minimum Tax Proposals

The same issue of proper useful lives for high technology equipment applies in the context of any proposed corporate alternative minimum tax. Many of the minimum tax proposals which this Committee will be considering include some measure of the acceleration in depreciation as a preference. CBEMA does not object to this in principle. However, the measure of any accelerated depreciation must take into account the actual rapid depreciation rates and short economic lives of high technology equipment. Otherwise, amounts will be treated as a preference and subject to minimum tax when in fact no benefits have been received by the companies in question and thus no minimum tax is properly due. The House bill accomplishes this result by using the actual lives of equipment -- rather than some arbitrary period -- as the starting point in measuring any minimum tax preference for accelerated depreciation.

Tax Treatment of International Operations

CBEMA members, and high technology companies in general, invariably have large international operations. The costs inherent in the R&D efforts to develop a new generation of products are sufficiently high that each generation of products must be sold in the broadest possible marketplace to provide needed revenues. Therefore, U.S. companies must compete for foreign markets. If U.S. companies are not competitive in these markets, foreign companies will develop a broader earnings base from which to finance larger R&D activities to develop their own future products. These future products will then be competitively superior to U.S. products not only in foreign markets but in the United States. Thus, U.S. companies must be competitive in foreign markets in order to remain competitive over the long-run even within the United

States. Consequently, the U.S. tax treatment of both the foreign operations of U.S. companies and U.S. exports is of vital importance to CBEMA members. Unfortunately, three of the provisions of the House bill with respect to the tax treatment of foreign operations of U.S. companies represent a significant backwards step.

Allocation of R&D Expenses to Foreign Source Income Under Section 861

The House bill does not extend the moratorium on the allocation of any R&D expenditures to foreign source income which has been in existence since 1981. Instead, it provides for an automatic allocation of 50 percent of R&D expenditures to U.S. sources, with the remainder allocated between U.S. and foreign sources. In effect, the proposal is a moratorium on one-half of R&D expenditures. Even this limited provision is not made a permanent part of the Code, but is extended only for two years.

The moratorium was originally enacted in 1981 because the allocation of R&D expenditures to foreign source income effectively denies the benefit of any R&D deductions for those costs to any taxpayer with excess foreign tax credits. The result is an actual disincentive for these taxpayers -- which under present law tend to be those R&D-intensive companies with substantial operations in high tax foreign jurisdictions -- compared to other U.S. companies not in an excess credit position and, more importantly, compared to foreign competitors. This policy rationale for the moratorium has not changed. Indeed, in the context of rate reducing tax reform, the disincentive becomes more widespread because more U.S. taxpayers will have excess foreign tax credits.

The Senate Finance Committee has taken the lead in adopting the moratorium on allocating R&D expenses in 1981 and then again in 1984 and 1985. The Committee should continue this effort in the context of tax reform by making the moratorium a permanent part of the Code.

Treatment of Foreign Affiliate Royalties

The House bill contains a provision, added without hearings or even much discussion at the end of committee deliberations, which abandons accepted standards for international taxation with respect to royalties paid by foreign affiliates to U.S. taxpayers. The provision will provide IRS agents with the legal basis to require increases in the royalty payments of foreign affiliates to U.S. parent corporations, thereby increasing U.S. taxes, even though foreign governments will not permit these additional payments to be deducted for local tax purposes. International double taxation of U.S. taxpayers will result in a way that can significantly affect the ability of U.S. companies to operate competitively on a worldwide basis. The provision should be rejected by the Senate Finance Committee.

Tax Treatment of U.S. Exports

Finally, the House bill proposal increases the taxation of U.S. exports by reducing Foreign Sales Corporation (FSC) benefits and eliminating any foreign source income from the sale of most goods manufactured in the United States. The FSC provisions were proposed in the Senate Finance Committee and enacted last year to exempt 15 percent of export profits from U.S. tax and reaffirm that up to 25 percent of total profits from export transactions could be treated as foreign source income and eligible for the foreign tax credit. For exporters with substantial foreign operations, the combination of these two provisions effectively reduces the U.S. taxation of exports by substantial amounts. The elimination of the source rule in particular would overturn this policy and increase U.S. taxation of exports. At a time when our trade deficits are at record levels, such a change in tax policy would seem to make little sense.

Alternative Minimum Tax

While a strengthened minimum tax is an appropriate element of a tax reform package, care should be taken so that such a tax does not act as a retroactive repeal of tax benefits that accrued in earlier years, especially tax benefits that encouraged particular investment behavior. Particularly because H.R. 3838's corporate alternative minimum tax rate is set at a rather high 25%, the decision not to allow all net operating losses to reduce alternative minimum tax income and not to allow any R&D credit or investment credit to reduce alternative minimum tax can act as a repeal, retroactively, of these credits and of the deductions which may have contributed to a net operating loss.

The House bill's allowance of a NOL carry-forward for alternative minimum tax purposes only if a NOL was incurred in two of the last three years should be expanded to permit NOL carry-forward for minimum tax purposes for any NOL generated prior to the effective date of the new minimum tax. Likewise, any investment tax credit or R&D credit carry-forward that exists as of the effective date of the new minimum tax should be permitted to be taken against such tax. The Treasury Department appears to recognize the unfairness of a retroactive repeal of investment credit through a high rate minimum tax in suggesting the allowance of investment tax credit carry-forwards against minimum tax to the extent of 75% of minimum tax liability (see Treasury Department Revenue Estimates on Alternative Tax Reform Options provided to Senate Finance Committee staff, February 12, 1986).

It is also important to avoid treating any FSC benefit enjoyed by a FSC shareholder as a preference item for alternative minimum tax purposes as H.R. 3838 would do. Treating those benefits as a preference would constitute an admission that the benefit is not simply a conscious mimicking of a territorial tax system (which would be GATT-legal) but is, instead, a departure from the U.S.'s normal taxing scheme, a tax subsidy lumped together with all other conscious tax subsidies. Such an admission will almost certainly raise GATT legality questions and undermine the whole purpose for substituting the FSC provisions for the DISC provisions in the 1984 Tax Reform Act.

Conclusion

CBEMA believes that properly structured tax reform can be a positive step in adapting our tax code to the increasing high technology nature of the U.S. economy. It therefore can help CBEMA members in international competition. The basic concepts of reduced tax rates, incentives for R&D and incentives for short as well as long-lived equipment establish positive principles for true tax reform. However, changes to the House bill are required consistent with these principles, particularly with respect to the depreciation. Equally important, several changes are needed in the bill's international tax proposals if the bill is to have a positive rather than a negative impact on international competitiveness.

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STATEMENT FOR THE RECORD

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Testimony for the Senate Finance Committee

U.S. Senate

February 21, 1986

on the Tax Treatment of Foreign Currency

Gains and Losses

Mr. Chairman and Members of the Committee, I am submitting for your consideration our analysis and recommendations on those provisions in the Tax Reform Act of 1985 (H.R. 3838), as passed by the House of Representatives, which concern the tax treatment of foreign currency exchange rate gains and losses. This testimony is submitted on behalf of my firm, Coopers & Lybrand, an international accounting firm with extensive experience in both the tax and accounting aspects of foreign exchange transactions.

As you may know, the present tax rules governing the treatment of gains and losses from foreign currency exchange transactions are at best unclear and in some instances nonexistent. Many of the rules were developed to address the tax treatment of investors entering into commodity type transactions, and, when applied to regular business transactions, result in unwarranted complexity and arbitrary results. Present law simply does not address some aspects of transactions involving foreign currency. For example, there is uncertainty relating to the tax treatment of "swaps," which are increasingly used in connection with financing transactions. This state of uncertainty is exceedingly unsatisfactory for taxpayers and the government alike in this day and age where international transactions are increasingly commonplace. Thus we commend the effort made in H.R. 3838 to provide a comprehensive set of rules to rationalize the U.S. tax treatment of transactions that involve foreign currency.

Our recommendations are intended as constructive support for this effort. In some areas we concur with the direction proposed in the Bill and recommend that it be broadened. In others, we don't agree with the approach taken and recommend alternatives. Overall, however, we support the effort and hope that the Committee will undertake the thought and study necessary to clarify and improve this area of the tax law.

What follows is a summary of our recommendations, followed by a more detailed discussion, in the three major issue areas of:

- foreign currency transitions,
- determination of earnings profits by foreign corporations, and
- earnings of foreign and branches.

Treatment of Foreign Currency Transactions. We support the general approach of the Bill, but we would like to see its application expanded. It also should be made explicit that taxpayers who, in a business context, enter into transactions in a foreign currency (i.e., denominated in a currency other than their functional currency) treat all resulting gains or losses as ordinary income or loss.

As to source rules, we recommend that consideration be given to a special rule for U.S. taxpayers using the dollar as their functional currency. This rule would neutralize exchange gains and losses for purposes of the source rules by treating such gains and losses as from U.S. sources and allocable to U.S. sources, respectively. This approach would totally remove foreign exchange gains and losses from the foreign source rules and would eliminate unwarranted interactions with the foreign tax credit limitation. For foreign entities, we suggest rules that generally would adjust interest income or interest expense as appropriate.

In terms of timing of recognition of such gains and losses, we agree with the Bill and recommend strongly that the "integration approach" be applied more broadly to situations where two or more transactions should be treated as a single economic unit. We are particularly concerned that the tax treatment of "swap" transactions be clarified, and we believe the present uncertainty has an inhibiting effect on transactions that are economically sound and should not be discouraged by the tax law.

Determination of Earnings and Profits Earned by Foreign Corporations and Related Deemed-Paid Taxes. We disagree with the changes proposed by the Bill in this area which would historically freeze the value of foreign taxes paid. It would result in significant additional complexity for no good policy reason; it is not an area of potential abuse by taxpayers; and its effects on taxpayers are arbitrary. It also results in a bias that reduces the foreign tax credit limitation.

We do support a uniform set of rules for computing earnings and profits and related foreign taxes. We recommend, therefore, that the present law approach (i.e., Bon Ami) be used more broadly where earnings are deemed distributed or otherwise taken into account under provisions of Subpart F and Section 1248. We include additional recommendations for a foreign corporation using the dollar as its functional currency. These include a recommendation that the Bill allow the dollar to be chosen as the functional currency for business units operating in countries of extraordinary inflation. We also disagree with the Bill's treatment of business-related exchange gains and losses as Subpart F income.

Earnings of Foreign Branches. We generally concur with the functional currency approach taken by the Bill with respect to branches. Again, we recommend that a taxpayer be allowed to use the dollar as the functional currency where the business unit operates in a highly inflationary environment. We also suggest that remittances from a branch not be considered taxable events but rather as adjustments to basis in the branch. Finally, the "at risk" concept should be deleted from the branch rules.

DETAILED ANALYSIS AND RECOMMENDATIONS

I. TREATMENT OF FOREIGN CURRENCY TRANSACTIONS

We support the general approach taken by the drafters of the Bill which establishes new rules for the tax treatment of transactions denominated in a currency other than the functional currency of the business unit. We understand that these rules would apply to a U.S. taxpayer for the purposes of determining U.S. taxable income and also would apply to a foreign entity where there is a need to establish the earnings and profits of that entity. We recognize that it is difficult to develop comprehensive rules for dealing with foreign currency transactions and our purpose is to offer comments which we hope would result in further clarification of the proposed rules and also result in equitable tax treatment where taxpayers are affected by significant swings in currency values.

Our comments deal with three major areas:

- character of gains and losses;
- source of gains and allocation of losses; and
- timing of recognition.

Character

We propose that a definition be developed which enables taxpayers who, in a business context, enter into transactions denominated in a currency other than their functional currency (foreign currency) to treat all resulting gains and losses as ordinary. We believe that the definition should include any transaction that is connected with a business activity. This definition would be significantly broader than that associated with the "Corn Products" doctrine and would include the following types of transactions: the acquisition of a debt instrument (defined to cover any form of indebtedness) or becoming the obligor under a debt instrument, and any form of contract the value of which will be affected by a change in currency or interest rate. Because of past uncertainty, this definition should specifically cover any type of transaction entered into by a taxpayer to reduce currency risk associated with an investment in another entity.

As a result of the broadening of the definition of transactions subject to ordinary income and ordinary loss rules, we recommend that all foreign currency transactions falling within the definition be specifically removed from the scope of Section 1256 (capital treatment for certain contracts and mark-to-market rule) and Section 1092 (loss deferral where there are straddles). We believe that these sections were designed to address the tax status of investors and that an unintended result has been that they have brought unwarranted complication into the analysis of the tax treatment of foreign currency transactions entered into in a business context.

Source

It is extremely difficult to satisfactorily address the issue of how exchange gains should be sourced and to what source losses should be allocated. Many taxpayers express serious concern that because of the wide swings in currency values the allocation of potential losses to foreign source income could result in very large and unpredictable reductions in net foreign source taxable income for the purpose of the foreign tax credit limitation. This risk is magnified by the rule that the recognition of exchange gains and losses is generally deferred to the date at which a liability is repaid or an asset realized. The impact on a given year can be dramatic. We therefore suggest that consideration be given to a special rule that would apply only to a U.S. taxpayer using the dollar as its functional currency. Under this rule, the source of exchange gains and the allocation of exchange losses would be neutralized by being treated as from U.S. sources and allocable, to U.S. sources, respectively.

For foreign entities, or as an alternative for U.S. taxpayers if the above recommendation is not acceptable, and as being more in line with the provisions of the Bill, we suggest that source rules be developed without the potential confusion that would result from generally characterizing certain exchange gains and losses as interest income or expense. We suggest the following rules:

1. Foreign Currency Denominated Asset. Any recognized exchange gain should be added to gross interest income earned by the asset for the purposes of applying the source rules only. If the proposals regarding the creation of separate foreign tax credit limitation "baskets" are retained, the gain or loss, because it is added to or deducted from interest, would flow into the basket appropriate to that particular type of interest. Any loss should be deducted from the gross interest income earned by the asset.

2. Foreign Currency Denominated Liability. Any recognized exchange gain should be deducted from recognized exchange interest expense for the purposes only of determining the amount of interest expense allocable under Reg. Sec. 1.861-8. Any loss should be added to interest expense.

3. All Other Business Connected Foreign Currency Transactions. Any exchange gain should have the same source as the business activity with which the transaction is connected. For example, a gain connected with the purchase or sale of inventory would be added to, and therefore have the same source as, the gross income from the sale of the inventory; a gain on a contract entered into in order to reduce currency risk associated with an investment in an entity would have the same source as the income or potential income generated by that entity; a gain on a swap transaction connected with a foreign currency liability would be connected with the liability and dealt with as in (2) above. (The same result would be reached under the integration approach discussed below.) Any exchange loss should be deducted from the gross income generated by the business activity with which the transaction is connected.

Timing of Recognition

We understand that it was the intention of the Ways and Means Committee to maintain the existing principles that (1) foreign currency gains and losses shoulq be treated as separate from related transactions, and (2) that gains and losses should be recognized at the time transactions are realized, such as through the sale or exchange of an asset or the actual repayment of a liability. Our recommendations follow these principles and address the very important exception relating to transactions that, due to the existence of a hedge or offsetting transaction, should be grouped and treated as a single economic unit (integration approach). We generally agree with the approach followed by the Bill in this area.

We recommend that the integration approach be applied where there is a factual relationship between any of the following types of transactions, in any combination and without regard to the date the transactions are entered into or recognized:

- Foreign currency denominated asset.
- Foreign currency denominated liability.
- Any form of contract (swap, forward, futures) the value of which will be affected by a change in currency rate or interest rate.

The factual relationship would be established by reference to documentation evidencing that two or more transactions can be treated as a single economic unit resulting in the effective and determinable offsetting of an exchange position or of a position regarding interest rates. We recommend that this treatment not be limited to transactions that are equivalent to dollar denominated transactions. This distinction is important since we believe that the integration approach is applicable to an entity using a currency other than the dollar as the functional currency. It should also apply where several transactions are entered into by a dollar functional currency taxpayer to establish a foreign currency position. For example:

> A taxpayer using the dollar as its functional currency borrows dollars and simultaneously enters into a contract to purchase, with an agreed amount of foreign currency ("FC"), the dollars required to repay the dollar borrowing at its maturity date. The two transactions are the economic equivalent of an FC denominated borrowing.

The issue should be whether, in combination, the transactions result in the offsetting of positions. This treatment should not be elective.

The current economic gain or cost of the integrated transaction would be brought into income in accordance with accrual principles, with all interest rate sensitive calculations being made on a yield-to-maturity basis. The integration principle would be applied only to the extent that the transactions, in terms of amount, nature of currency and timing, constitute a single economic unit, have a predictable and determinable result, and are effective in offsetting exchange or interest rate positions. These principles can be illustrated by way of an example:

On January 1, 1986, a taxpayer using the dollar as its functional currency borrows 100,000,000 units of foreign currency ("FC") for six years at a fixed interest rate of 5%, at a time when the exchange rate is \$1.00=FC2.50. In January 1987 when the exchange rate is \$1.00=FC2.00, the taxpayer enters into an agreement under which it will receive from a counter-party on December 31, 1991 100,000,000 units of FC in exchange for \$50,000,000. In the meantime, periodic exchanges will occur under which the taxpayer pays the counter-party \$4,500,000 per year (9% of the dollar principal amount of the swap) and receives in exchange 5,000,000 units of FC (5% of the FC principal amount of the swap).

For the 1986 year, the taxpayer's FC liability is not offset. The taxpayer would deduct the current dollar value of the 5,000,000 units of FC as interest cost. The dollar value of the liability has increased by \$10,000,000 as of December 31. Since there is no realization event, this loss will only be deductible in the year of repayment. For years subsequent to 1986 the liability and the swap constitute a single economic unit. Applying accrual principles, the annual cost of the hedged borrowing to the taxpayer is \$4,500,000: an effective cost of 9% on a yield to maturity basis. This amount would be deductible as accrued interest expense. Assuming no further transactions, gains and losses on the swap and on the repayment of the liability occurring on December 31, 1991 will offset each other except to the extent of the $10,000,000 loss which will now be deductible as ordinary income.

If, subsequent to 1986, the taxpayer entered into another swap that economically offset the swap entered into on January 1, 1986, the integration of the three transactions would result in the taxpayer being once again exposed to a currency position on the FC denominated liability. The taxpayer would once more have deductible interest expense based on the dollar value of the 5,000,000 units of FC plus or minus the current positive or negative margin, calculated on a yield-to-maturity basis, resulting from the integration of the two offsetting swaps. The margin would generally be attributable to changes in market conditions that occurred between the date the original swap was negotiated and the date the second swap was entered into. Any margin should be currently includible or deductible and it should adjust the current interest expense on the liability since the two swaps were entered into, albeit at different times, in connection with the management of the liability. At the date of repayment of the FC denominated liability, the taxpayer would recognize ordinary income or loss. Gain and loss on the swaps at maturity would offset each other.

Other Comments Regarding Foreign Currency Transactions

Confusion exists where payments are made to a foreign counter-party under a swap transaction as to whether such payments could possibly be considered interest income (since they are computed by reference to interest rates) or some other category of periodic income and therefore subject to withholding. We recommend that it be clarified that payments made to a non-U.S. person on a swap contract be excluded from the definition of fixed, or determinable annual or periodical income for the purposes of determining liability to tax under Sections 871 and 881. A swap can be defined as any form of contract entered into by a taxpayer for the purpose only of establishing a position with respect to a currency or to an interest rate fluctuation or to a combination of the foregoing.

Subpart F rules are modified by the Bill so as to treat as Foreign Personal Holding Company income any gains attributable to foreign currency transactions unless the transactions are "directly related to the business needs of the taxpayer." We believe that this exclusion from Subpart F is unduly narrow and that, in line with our recommendations regarding the characterization of foreign currency transactions under Section 988, all transactions entered into in a business context should be outside the reach of Subpart F. We believe that this broadening of the exclusion is also required to avoid the undue complexity resulting from the Bill's attempt to include foreign currency foreign source gains as passive income for the purposes of the foreign tax credit limitation. We further argue that no business related foreign source foreign currency gain should be included in the passive basket. The Bill would include in the separate basket even narrowly defined business related gains if realized by a taxpayer using the dollar as its functional currency. This rule would be particularly burdensome for gains realized by foreign entities whose functional currency is the dollar.

II. DETERMINATION OF EARNINGS AND PROFITS BY FOREIGN CORPORATIONS

Present law provides a simple rule for determining the dollar equivalent of foreign earnings distributed to a U.S. corporate shareholder by a foreign corporation. The rule is patterned after a 1939 Tax Court case (Bon Ami) and provides that the taxable amount of the dividend is determined simply by finding out what it is worth in U.S. dollar terms when received by the U.S. shareholder. The U.S. shareholder is entitled to a credit for foreign taxes paid by the foreign corporation to the extent that they are attributable to earnings distributed by way of the dividend. According to these same rules, the foreign taxes are also stated in U.S. dollars at the rate used to determine the value of the dividend actually received.

The Bill overturns Bon Ami by introducing a new and highly complex computation requiring that the earnings of the foreign corporation and the foreign taxes related to those earnings be stated in dollars by reference to the exchange rates prevailing at the time the earnings were accumulated and the foreign taxes actually paid. The overriding concern of the drafters of the Bill seems to have been to ensure that the dollar equivalent of the foreign taxes be linked precisely to the exchange rate in force at the time of actual payment of the taxes. It is easy to see why this approach results in additional computational complexity; there is, of course, no relationship between the dollar value of the dividend when received and the historic rates used to compute the earnings out of which it was distributed and the foreign taxes related to those earnings. Any exchange rate change will result in the numbers being incompatible. The Bill deals with the problem by treating the difference as if it were a foreign exchange gain or loss. It requires that this difference be included in a newly created special purpose "separate basket" for the purposes of the foreign tax credit limitation rules.

We take exception to this change for two main reasons. Firstly, it results in significant additional complexity for no demonstrably good policy reason. The complicating factors include the following:

- The creation of an "exchange difference" every time a dividend or deemed-dividend transaction occurs.

- The need to maintain detailed records of exchange rates every time a foreign corporation accounts to a foreign tax authority. This assumes erroneously that U.S. shareholders can make unlimited information demands of their foreign subsidiaries.

- These computational complications are even greater when they are considered in the context of the need.

- An accounting for earnings and profits on an average or "pooled" basis. A complete history would have to be maintained of all components of a pool, even though from a practical or business point of view. a dividend is from current profits. The pooling concept would also magnify the amount of the "exchange difference" where a currency has fluctuated significantly over time even though, again, in practice a distribution may have a current source.

The Bon Ami approach insures that the relationship between the foreign taxes paid and the foreign earnings on which those taxes were paid remains constant. Granted, under Bon Ami the dollar value of the tax is not historically fixed. However, we do not view this as an undesirable result from a policy point of view since the dollar equivalent of the foreign earnings on which the taxes were paid will correspondingly increase or decrease as exchange rates change between the date of their accumulation and their actual distribution. Thus the tax remains a constant percentage of the earnings on which it was paid.

The impact of the complex new rules on a U.S. taxpayer would be at best arbitrary. We have developed test computations based on an example included in the Ways and Means Committee Report, and these are included as an attachment. Our computations test the impact on a U.S. taxpayer shareholder depending on whether the foreign currency rises or falls against the dollar. We have also tested for another variable: the rate at which the foreign earnings are taxed in the foreign country. Our computations compare the Bill's rules with Bon Ami. They clearly indicate that the effect on the U.S. tax liability of the U.S. shareholder is arbitrary in that U.S. taxable income is increased or decreased depending on the direction of the change in exchange rate.

We cannot see a good reason for replacing straightforward rules used for many years by vastly more complex ones when the result is arbitrary and arguably less logical. We are not persuaded that freezing the dollar value of foreign taxes paid by a foreign entity should be an overriding policy objective. This freezing of historic rates is sometimes justified by pointing out that a U.S. taxpayer operating in branch form in a foreign country credits foreign taxes paid by reference to their dollar value at the date of payment. We are not persuaded that there is a policy need to equate the treatment of a foreign branch and a foreign subsidiary. The financial resources of an operating foreign subsidiary are, as a practical matter, insulated from those of its shareholder until such time as earnings are distributed. Funds typically flow more freely between the branch and head office, particularly in the case of a financial business. Outside the financial services industry, relatively few U.S. taxpayers permanently conduct substantial business operations overseas in branch form.

Our second exception to this change is that these complex rules should be viewed in connection with the proposed changes to the foreign tax credit limitation rules. The approach taken by the Bill inevitably results in a difference between historically computed numbers and the actual value of the dividend when received. Where exchange rates fluctuate significantly over time, this difference will be magnified out of all proportion through the concept that earnings and profits are "pooled." Even a distribution that is economically out of recent earnings will be considered to come out of a historically computed pool. Having created this difference, it is arbitrarily referred to as an exchange gain or loss.

To add further to the complexity, this special adjustment is treated as "foreign" but consigned to a separate special purpose basket for the purposes of the foreign tax credit limitation. If the basket is positive, the taxpayer is precluded from obtaining any benefit with respect to the foreign tax credit limitation. However, if negative, it must be allocated against other foreign baskets with the result that it will generally be a further hurdle in the process of attempting to credit foreign taxes. The computations we developed to test the impact of these rules indicate that the invariable result is to put further pressure on the foreign tax credit limitation amount. We do not believe that this result is warranted.

In summary, we question not only the wisdom of increasing complexity for the sake of the theory that the value of foreign taxes paid by a foreign entity should be historically frozen, but also question whether it is reasonable that the adoption of this approach should be allowed to result in a bias towards a further reduction of the foreign tax credit limitation amount.

We do, however, support the principle that a uniform set of rules should be used to compute earnings and profits and foreign taxes related to those earnings and profits. We therefore recommend that the Bon Ami approach be used not only when taxable distributions are made to U.S. shareholders but also where earnings are deemed distributed or otherwise taken into account under provisions such as those included in Subpart F and Section 1248 of the Code.

Bon Ami would be applied by requiring that all earnings and profits calculations be made in terms of the foreign corporation's functional currency. Assets and liabilities denominated in a currency other than its foreign currency would, each year, be restated in the functional currency in terms of current value and the resulting differences added or subtracted from functional currency earnings and profits.

In the case of a foreign corporation using the dollar as its functional currency, all foreign currency transactions would be stated in dollars at rates designed to approximate historic dollar equivalents. The annual restatement of non-dollar denominated assets and liabilities and the inclusion of the resulting differences in earnings and profits would ensure that accumulated earnings and profits are consistently stated so as to reflect their current dollar value. A question remains as to which exchange rate should be used to state in dollars the foreign taxes been paid by the, foreign corporation. We believe that the correct economic answer is that the foreign currency amount of the taxes should be converted into dollars at the rate that is current on the date of the dividend payments or on the date the earnings are deemed distributed or otherwise taken into account. This treatment would parallel the result obtained where the foreign corporation's functional currency is other than the dollar. It also maintains a logical relationship between the value of the tax and the current valuation of the earnings and profits.

The principles on which these recommendations are based lead to earnings and profits having a similar value whether the foreign corporation uses the dollar as its functional currency or uses a foreign currency. However, this similarity may no longer obtain if the foreign corporation carries substantial assets, or liabilities, that are not monetary (i.e., not denominated in foreign currency or dollars).

If, for example, a foreign corporation with substantial fixed plant and equipment uses as a functional currency a local currency that depreciates very significantly over time, the local currency depreciation charge will become insignificant in relationship to its operating income. We therefore recommend that the election under the Bill, whereby the dollar may be chosen as the functional currency for certain qualified business units (Sec. 985(b)(3)), be expanded to allow this choice where the currency of the country in which the business unit operates is subject to extraordinary inflation. This recommendation follows the principles adopted by FASB 52 regarding highly inflationary economies and recognizes the reality that dollar measurement is a more accurate gauge of economic gain or loss under such circumstances. The election should not be dependent on the books of the foreign corporation being maintained in dollars. FASB 52 includes rules that result in a reasonable restatement of transactions in dollar terms.

happy to discuss these and other issues, or to address any questions that may arise, with the Committee and its staff at your convenience.

AN ANALYSIS OF
TAX REFORM PROPOSALS
relating to
TAX SHELTERED ANNUITY PLANS
Under Section 403(b)

for the hearings record

February 6, 1986

Hearings on H.R. 3838
and other comprehensive tax reform legislation

Committee on Finance
United States Senate

submitted by
THE COPELAND COMPANIES

BACKGROUND

INTRODUCTION.

Section 403(b) of the Internal Revenue Code authorizes an exclusion from federal income taxation of certain amounts of an employee's compensation which are contributed by the employer for the purchase of an annuity contract which is specially designed to provide for retirement savings.

Taxes on the amounts contributed are deferred until a distribution is received at retirement. Amounts received during retirement are fully taxable as ordinary income when actually received, without the benefit of ten-year averaging or capital gains treatment.

WHO IS ELIGIBLE?

The provision for the use of a tax sheltered annuity [TSA] is available only to employees of tax-exempt charitable, educational, and religious organizations that are recognized pursuant to Section 501(c)(3) of the Internal Revenue Code.

The largest elements of the employee population that are included in this definition are: public school teachers, university professors, nurses and other hospital workers, church employees, and employees of charities.

PROFILE OF THE AVERAGE TSA PARTICIPANT:

The tax sheltered annuity provision was intended primarily for use by middle-income employees. In fact, TSA has developed as a highly consumer-oriented retirement savings vehicle, and has overwhelmingly been used by middle-income employees.

Analysis of the TSA participant base * enables us to develop a profile of the kinds of people who use the tax sheltered annuity provision:

- **The average participant has a salary between $20,000 and $30,000.**
- **For more than 80 percent of participants, total family income is less than $40,000.**
- **The average annual deferral is $2,800.**

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* The Copeland Companies has a client base of roughly 150,000 employees. This client base is highly representative of the TSA market because Copeland is the only national marketing organization that represents a wide variety of investment products provided by several different carriers; most TSA agents represent only the products of one insurance company.

RATIONALE FOR TSA:

In legislating the special provision for tax sheltered annuity arrangements, Congress recognized that the needs of employees in the non-profit sector are very different from the needs of employees in the private sector. Primarily, these differences have to do with the amounts and the nature of the compensation paid to employees.

Employees of the private sector are generally higher-paid than employees in the public or non-profit sector. Private pension plans can be quite generous, providing employees with a substantial retirement income at little or no cost. In addition, these employees frequently have the opportunity to elect to save additional amounts on a tax deferred basis through the use of several kinds of defined contribution plans, including Section 401(k) plans. Further, the private sector employee may participate in Employee Stock Ownership Plans [ESOPs], and in many other tax-advantaged benefits programs that are unavailable to the employee in the non-profit sector. In particular, participation in stock plans often provides many private sector employees with a larger amount of income than their pensions.

Employees of the non-profit sector are generally somewhat lower-paid than employees in the private sector. Therefore, a somewhat larger percentage of their total compensation must be devoted to retirement savings in order to achieve a similar level of retirement income. Thus, Congress believed it was appropriate to legislate an exclusion allowance for TSA that would permit the employee to defer a meaningful, though not excessive, amount of compensation for retirement savings. Toward that end, the TSA exclusion allowance is coordinated with and reduced by contributions made to any other retirement plan (except an IRA).

For many non-profit institutions, the Section 403(b) plan is the primary, or, in many cases, the only plan for providing retirement savings. * This is especially true in the college and university environment, where the TSA plan typically is the basic retirement plan. This is also typically true for organizations with a relatively small number of employees.

Recognizing that many non-profit employers do not have the resources to establish and administer a qualified plan, Congress legislated the tax sheltered annuity provision as an alternate method of allowing employers to help employees provide for their retirement.

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* Many of the tax-exempt charitable and educational organizations that are eligible to offer a TSA plan to their employees use the TSA plan as their only retirement plan, primarily because the use of a TSA plan requires only minimal administrative involvement by the employer.

WHAT IS A TAX SHELTERED ANNUITY?

A tax sheltered annuity [TSA] contract is a specially designed investment vehicle that accumulates funds saved for retirement purposes. Contributions to the annuity contract must be made by the employer.

The funds contributed may be amounts (in addition to salary) set aside by the employer. However, the far more usual source of the funds contributed is the direct compensation of the individual employee; that is, the individual employee agrees to "reduce" salary or to forego a certain portion of compensation in return for a promise from the employer that it will contribute the unpaid amounts to a tax sheltered annuity contract. In either case, the TSA plan is used as a basic retirement plan.

The annuity contract must be designed so as to ensure that the accumulated funds will be used for retirement purposes. Thus, the contract must be both non-forfeitable and non-transferable, so that only the individual for whom the retirement savings are made can possess any right to the funds. Also, the contract must contain substantial withdrawal restrictions, so that the employee will generally be unable to draw on the accumulated funds until retirement. Finally, the contract is subject to several distribution rules, which are designed to ensure that the proceeds will be used during the retirement of the employee and will not be passed on to heirs or other beneficiaries.

It should be noted that the use of a tax sheltered annuity does not completely shelter from income tax the amounts of compensation deferred or the investment earnings attributable to those amounts. Rather, the income tax is merely deferred until the compensation deferred is actually paid at retirement. All amounts paid out from the tax sheltered annuity are taxed as ordinary income in the year when received, and ten-year averaging is not available. Thus, TSA is fully taxed.

LEGISLATIVE HISTORY.

Before 1958, the Internal Revenue Code had long contained various provisions designed to encourage certain charitable, educational, and religious organizations to set aside savings to provide for the secure retirement of their employees. These provisions had virtually no limits or restrictions, largely because of the ambiguous language of the Code provision and the Regulations interpreting the provision. Naturally, the confusion led to abuses of the provision. This prompted Congressional scrutiny into the terms of the Code provision.

In legislating the current Code provision for tax sheltered annuity contributions [Technical Amendments Act of 1958, Pub. L. No. 85-866 Section 24(a)-(c)], the Congress sought to curtail abuses by clarifying and redefining the terms of the earlier law.

The amendments were focused primarily on defining appropriate restrictions on the use of the tax sheltered annnuity [TSA] arrangement. In particular, Congress was concerned that income deferrals be limited to an appropriate amount.

Contribution Limits: Although Congress wished to preserve this unique tax incentive encouraging retirement savings, one of the goals of the legislation was to limit the amount of income that could be deferred to a reasonable amount, in keeping with the purpose of encouraging retirement savings, and not resulting in an excessive or unfair deferral of income when compared to qualified retirement plans.

Thus, Congress legislated an explicit and highly detailed exclusion allowance designed to limit the amount of compensation that could be deferred from income tax. The terms of this exclusion allowance were designed to accomodate the particular patterns of compensation used by employers in the non-profit sector.

This facet of the legislation became especially apparent in 1974 when Congress amended the exclusion allowance to permit an alternative of certain "catch-up" limits, which are designed to allow an employee to "make up for lost time" by permitting somewhat larger contributions if the employee has not fully utilized previous opportunities to make contributions for retirement savings. This alternative is based on the recognition that many younger employees may not have sufficient discretionary income to make meaningful contributions toward their retirement savings.

This legislative recognition of the particular needs of employees who are saving for their retirement from their own direct compensation indicates that the TSA exclusion allowance is designed to accomodate the special needs of employers and employees in the non-profit sector.

Further, the legislative history indicates that this exclusion allowance was intended as a complete alternative to the non-discrimination rules applicable to qualified plans.

RESPONSES TO SPECIFIC PROPOSALS

CONTRIBUTIONS LIMITS.

Proposal: The House Bill would generally reduce the amounts that may be contributed under a TSA plan by imposing a $7,000 "cap" on "elective" deferrals (i.e. salary reduction contributions).

Analysis: For the first time, a distinction would be established under TSA plans between contributions made by the employer from its own funds and contributions made through an agreement for salary reduction.

This distinction, however, may be illusory. In practice, few TSA plans provide for actual employer contributions. This is almost universally the situation for those public schools (virtually all) that make a TSA plan available to their employees, and is also true of the vast majority of tax-exempt organizations. This is simply because most public schools and tax-exempt organizations cannot afford any employee expenses beyond those already being paid.

Further, many employers look upon the need for retirement savings as a personal obligation of the individual employee. In this regard, they believe that each individual employee must decide for him/herself what level of retirement savings is appropriate for his/her individual circumstances. In this sense, the salary reduction arrangement which has typically been used as the basis of the vast majority of TSA plans is efficient in allowing employers to let employees decide for themselves what level of retirement savings is appropriate, rather than being bound to an across-the-board formula covering all employees, regardless of individual circumstances.

The current TSA exclusion allowance is designed to recognize these concerns. The TSA exclusion allowance was designed according to the assumption that all contributions under the plan would be made through salary reduction. [Report of the Senate Finance Committee on the Technical Amendments Act of 1958.] *

The existing limits provided by the TSA exclusion allowance have been successful in achieving their legislative purpose - ensuring that TSA participants may make meaningful, though not excessive, contributions to their retirement savings.

A TSA plan needs to have somewhat generous contribution limits because the TSA plan is often the only retirement plan available for the employee. This is almost always the situation for private colleges and universities, and is often now the situation for many public universities. This is also typically true of smaller tax-exempt organizations, which cannot afford to provide for or to administer a qualified pension plan.

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Because of this posture of the TSA plan as the only or the primary retirement plan of many schools and tax-exempt organizations, it is essential that the tax law not discourage voluntary retirement savings by unfairly limiting the amounts that may be contributed under a TSA plan.

IRA COORDINATION RULE:

Proposal: The House Bill would provide that an individual's IRA deduction limit is reduced, dollar-for-dollar, by the amount of any elective (i.e. salary reduction) contributions under a TSA plan. [JCT Summary, p. 35.]

President's Alternative Proposal: The "first-dollar" offset would be replaced with a "last-dollar" offset. [Alternative Proposal, p. 15.] This means that an employee would be limited to a combined (TSA plus IRA) elective deferral of $7,000.

Analysis: The President's recent Alternative Proposal would be more effective and appropriate than the corresponding provision of the House Bill in achieving the stated policy objective of the tax-writing Committee.

The Committee's chief goal was to limit the sum of retirement savings through all available plans to a single dollar limit. [See House Ways and Means Committee Report, p. 683.]

This objective can be achieved by either of the IRA coordination rules proposed. Under either proposal, an employee would always be limited to combined voluntary retirement savings of $7,000 (or whatever other dollar limit may be established). The difference lies in the timing of contributions and in the matter of which plan is to be favored.

Under the provision in the House Bill, an employee who chose to make his/her full $2,000 IRA contribution would be effectively prevented from participating in the TSA plan - because any contribution to the TSA plan will reduce the IRA limit, and the IRA contribution has already been made. * We believe that such a result was not intended by the House Ways and Means Committee.

Unfortunately, the effect of the provision in the House Bill is to remove an employee's opportunity to choose to allocate his/her retirement savings between different plans and different investments.

The provision in the House Bill also produces the unintended consequence of limiting retirement savings opportunities for middle-income taxpayers. According to the Committee, the IRA coordination rule is intended "to improve the distribution of IRA utilization among all income groups." [House Ways and Means

Committee Report, p. 683.] However, the effect of the provision in the House Bill would not achieve this purpose. In general, the provision would do nothing to limit the discretionary retirement savings of upper-income employees, since they would be primarily restrained by the $7,000 overall limit. But the effect of the provision is to sharply limit retirement savings by those employees (generally middle-income employees) whose TSA exclusion allowance is somewhat less than the $7,000 overall limit.

The President's Alternative Proposal would resolve these unintended consequences and permit greater flexibility of plan and investment choice by providing that the coordination between the IRA limit and the TSA plan elective limit is a "last-dollar" rather than a "first-dollar" offset.

This restatement of the IRA coordination rule would more efficiently serve the stated policy goal of the tax-writing Committee - that is, to limit the sum of all voluntary retirement savings to a single unified dollar limit. Thus, in no event would any employee be permitted to defer more than $7,000 (or whatever other dollar limit may be established).

This rule would be simpler to administer because it would eliminate the timing and calculation problems inherent in the "first-dollar" offset. Further, this rule would not interfere with the flexibility of the participant's plan and investment choices.

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* Under the provision in the House Bill, any employee who wishes to contribute toward his/her retirement savings in an amount greater than $2,000 may do so only by participating exclusively in the TSA plan.

Assuming that the Senate Finance Committee agrees with the policy goals of the House Ways and Means Committee with respect to limiting voluntary retirement savings, a better IRA coordination rule for use by TSA participants would be to provide that any contribution to an IRA reduces a participant's "includible compensation" [IRC Section 403(b)(3)] for purposes of calculating the participant's exclusion allowance [IRC Section 403(b)(2)]. This would more accurately calculate the impact of an IRA contribution (since the effect of an IRA contribution is, in essence, to reduce taxable income), while still achieving the Committee's purpose of limiting the combined amounts that any participant may contribute toward both plans.

WITHDRAWAL RESTRICTIONS.

Proposal: The House Bill would provide that no withdrawals may be made from a TSA plan prior to the time an employee attains age 59 1/2, separates from services, becomes disabled, or dies. The House Bill would permit early withdrawals (of elective contributions only without accumulation) upon a showing of financial hardship. Any such early withdrawal would be subject to ordinary income tax and to a 15 percent penalty tax. [JCT Summary, p. 38.]

Analysis: The provision in the House Bill recognizes the policy concern of the tax-writing Committee that the tax law ensure that TSA retirement savings be used for retirement purposes. While recognizing this policy concern and its role in the overall policy objective of encouraging employees to provide for retirement, we believe that this goal may be achieved without any provision for a penalty tax.

In general, a penalty tax is not needed because an employee will not normally have access to his/her TSA retirement savings unless s/he can demonstrate financial hardship. Thus, in most instances an employee will not be capable of receiving an early withdrawal.

In situations where an employee is permitted access to his/her TSA savings before retirement (i.e. separation from service), s/he will usually still be employed (moving to a new employer) and will generally have a strong incentive to preserve the tax-free status of his/her TSA retirement savings. This incentive is further supported by the fact that most employees in the non-profit sector tend to remain in the non-profit sector; thus, they retain their opportunity to use the TSA plan with the new employer. In most cases, employees simply continue contributing to the same TSA contract, or transfer their savings to a similar TSA contract which will receive ongoing contributions.

Although a penalty tax would certainly have the desired effect of penalizing early withdrawals, a penalty tax would be counterproductive since it would discourage middle- and lower-income employees from participating in the retirement savings plan. Thus, the penalty tax is inconsistent with the more general policy goal of encouraging employees to participate in retirement savings plans.

Further, a penalty tax is unnecessary because all TSA distributions are fully taxable as ordinary income when received. Since employees are likely to be at or near their highest marginal tax bracket during the working years before retirement, they have a strong disincentive discouraging withdrawals before retirement. In general, employees are aware that an early withdrawal destroys the special tax advantage of a TSA plan - that is, that the income will be taxed at a lower rate after the individual retires, rather than at the high marginal tax rate that applies when the individual is working. Thus, any gain that has accrued under a TSA plan which will not be used for retirement purposes will be fully taxed.

By eliminating any penalty tax imposed upon early withdrawals from a TSA plan, the Senate Finance Committee would make the treatment of TSA plans the same as the treatment of Section 401(k) plans - that is, that withdrawals are permitted for hardship only, but there is no additional tax imposed. [See House Ways and Means Committee Report, p. 692.]

The House Bill provides that early distributions (of salary reduction contributions only without accumulation) "may be made in the case of hardship." [House Bill Section 1123(c)(1).] The House Bill does not provide a definition of what constitutes "hardship," and does not provide for who is to determine whether a hardship exists. We respectfully suggest that a clarifying amendment may be helpful if this provision is to be retained.

To establish a definition for hardship, we suggest that the standards applicable to cash or deferred plans pursuant to Section 401(k) [See Proposed Regulations Section 1.401(k)-1(d)(2)] may also be appropriate for TSA plans.

However, in determining the existence of a hardship, we submit that this responsibility should be placed upon the individual employee. TSA plans have been successful in achieving their legislative purpose of encouraging appropriate retirement savings largely because of the minimal involvement required of the employer in administering the plan. To destroy the administrative ease of the TSA plan by requiring the employer to make determinations with respect to the personal financial condition of individual employees would eliminate one of the most significant advantages of the TSA plan.

NON-DISCRIMINATION RULES.

Proposal: The House Bill would impose non-discrimination rules similar to those now required for qualified plans. [JCT Summary, p.37.]

Analysis: There should be no need for non-discrimination rules to apply to a TSA plan. To begin with, employees in the non-profit sector are generally lower-paid than private sector employees, and in particular the range of salaries is much narrower. There has been no evidence of abuse by highly-paid employees. Rather, experience has shown that TSA is used overwhelmingly and almost exclusively by the middle-income employees for whom it was intended.

It should be noted that the TSA exclusion allowance is designed to counter the problem of discriminatory usage in that previous contributions to the Section 403(b) plan or to any other retirement plan will reduce the maximum amount that may be excluded. Employees who have made unusually large contributions for even a few years will find that the exclusion allowance has been dramatically reduced, and that they must then substantially reduce ongoing contributions to eliminate the disparity in usage. Thus, the exclusion allowance fully addresses the concern of discriminatory usage.

As noted before, in legislating Section 403(b), Congress intended that the exclusion allowance would be a complete substitute for the non-discrimination rules applicable to qualified plans.

Congress legislated this alternative based on their recognition that many non-profit employers, especially smaller employers, are not capable of administering a retirement plan according to the exacting standards of a qualified plan, and that these standards are not necessary to protect employees in the public and non-profit sector. This understanding of legislative purpose comports with the beliefs and attitudes of employers in the non-profit sector.

Recent industry experience indicates that employers have very little more patience with burdensome compliance requirements, and do not have the administrative capability to operate their plans according to new requirements. Given a new set of non-discrimination rules to follow, many employers would simply resolve the problem by sharply curtailing the use of TSA plans by their employees.

IS THERE A NEED FOR TAX REFORM?

An analysis of the tax reform proposals now before the Congress, together with an understanding of how tax sheltered annuity plans have in fact been utilized by a wide variety of employees in the non-profit sector, strongly indicates that there is no need for reform in this area.

Rather, the provision for tax sheltered annuities has been doing just what it was meant to do - helping millions of mostly middle-income employees voluntarily save for a secure retirement.

At the same time, many experts in the employee benefits and pensions fields have expressed alarm at the continuing pace of legislative developments. In the past four years alone, there have been five major tax reform acts - the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Social Security Amendments of 1983, the Tax Reform Act of 1984, and the Retirement Equity Act of 1984. Each of these has had a significant impact on the retirement planning area. A recent opinion survey conducted by the International Foundation of Employee Benefit Plans showed that 85 percent of the experts believed that the continuing stream of new law has eroded employers' enthusiasm to design, maintain, or even offer attractive employee compensation packages. In short, employers are "sick and tired" of having to change their pension plans.

Perhaps now is not the time for change.

CONCLUSION

There has been no evidence that the provisions of Section 403(b) have been abused or utilized in a manner other than that intended. Instead, the provision has been highly successful in achieving its legislative purpose - helping millions of mostly middle-income employees save, from their own funds, for a secure retirement.

In particular, the contribution limits have proved workable and appropriate. They have limited the amount of income that may be deferred to a reasonable amount necessary to provide for retirement. Also, the exclusion allowance has fulfilled its subsidiary purpose of restraining discriminatory usage.

TSA has been widely used by the group of employees for whom it was intended. By definition, these people are typically middle-income employees. Because of the nature of the organizations by which they are employed, they have a much smaller range of benefits available to them than are found in the private sector. TSA has helped the employees of the non-profit sector to achieve some parity with those in the private sector.

RECOMMENDATION

When Congress enacted the existing law pertaining to the use of a tax sheltered annuity, careful consideration was given to developing a workable program that would serve the particular needs of employers and employees in the non-profit sector. Those considerations gave rise to a detailed legislative scheme that was especially well-drafted to accomplish its purpose.

Since then, nothing has changed. The same economic conditions exist now. And the use of tax sheltered annuity plans has become a highly consumer-oriented means of saving for retirement.

Therefore, our simple recommendation must be:

Section 403(b): NO CHANGES.

February 18, 1986

COMMENTS OF CENSA AND ICPL ON H.R. 3838 - PROPOSALS FOR TAXATION OF FOREIGN TRANSPORTATION INCOME

This paper addresses the proposals for the taxation of foreign transportation income, as contained in the "Tax Reform Act of 1985," passed by the House of Representatives on December 17, 1985, and currently before the Senate Committee on Finance. These comments are submitted on behalf of the Council of European & Japanese National Shipowners' Associations (CENSA), and the International Committee of Passenger Lines (ICPL). CENSA is comprised of the National Shipowners' Associations of Belgium, Denmark, Finland, France, Federal Republic of Germany, Greece, Italy, Japan, the Netherlands, Norway, Sweden and the United Kingdom, plus individual liner operators/container consortia from most of those countries. ICPL is an Owners Committee of nineteen major passenger cruise lines. These companies own and operate some eighty passenger vessels world-wide, comprising more than 85% of all cruise traffic, a substantial percentage of which is to and from U.S. ports. 1/

1/ The ICPL member lines are: Bahama Cruise Line, Carnival Cruise Lines, Chandris America Lines, Costa Line, Cunard Line Limited, Eastern Cruise Lines, Epirotiki Lines, Holland America Line, Home Lines, Norwegian Caribbean Lines, Ocean Cruise Lines, P & O Cruises, Pearl Cruises of Scandinavia, Premier

[Footnote continued]

The House Bill would alter the taxation of transportation income in three significant ways:

(1) A new 4% "gross basis" tax would be imposed on the U.S. source shipping income of foreign persons.

(2) The foreign source rules, in effect since 1922, would be revised to source all transportation income attributable to U.S./foreign and foreign/U.S. routes as 50% U.S. source income and 50% foreign source income.

(3) Code § 883, in effect since 1921, would be amended so that the tax exemption provided for shipping income would be available only if the foreign person's country of residence gives U.S. persons an equivalent exemption.

1.) We are opposed in principle to the proposed new tax on shipping income, and believe that if it is introduced it should only be applied against those countries who impose a similar tax. The collection of such a tax would be very difficult and expensive.

1/ [Footnote continued]

Cruise Lines, Royal Caribbean Cruise Line, Royal Viking Line, D.F.D.S. - Sea Escape Cruises, Sitmar Cruises and Sun Line Cruises.

2.) The proposed source rule change would be counterproductive and invite the very double taxation it seeks to avoid.

3.) The proposed test of residence rather than flag would create serious problems of interpretation, administration, and compliance.

Summary of Comments

These provisions of the House bill are substantially the same as those previously considered and rejected by Congress in 1976-1980. They would revise substantially U.S. tax rules respecting foreign shipping income which have been in effect for over 60 years, and which have demonstrably accomplished the purposes they were intended to accomplish -- encouraging the adoption of uniform international tax rules affecting shipping companies and eliminating the risk of double taxation on shipping income.

The proposed changes are apparently urged in the belief that they would (a) assist the U.S. in dissuading certain developing countries from imposing gross receipts taxes of their own on U.S. ships using their ports; (b) remedy an alleged defect in the present U.S. tax rules whereby only that part of the shipping income attributable to the period that foreign ships are actually in U.S. waters is potentially subject to U.S. tax; and (c) cure an alleged defect in the present rules, whereby reciprocal tax exemption can be obtained by registering ships under the laws of an appropriate country, regardless of where the shipowners reside.

We submit that (1) the proposed changes will likely have little or no effect in persuading developing countries from imposing gross receipt taxes on foreign shipping income; (2) the alleged defects in the present statutory rules are a conscious expression of long-standing U.S. policy, which has accomplished its purpose by obtaining a remarkable degree of uniformity respecting taxation of shipping income by the developed countries of the world, thereby avoiding double taxation, and by securing equivalent exemptions from tax for U.S. and foreign shipping alike; and (3) the proposed changes would at best result in relatively insignificant additional revenues, and these revenues would likely be exceeded by additional governmental and other costs, including:

(i) The costs to the U.S. Government of extensive and complex administrative arrangements (the details of which have not been thought through) necessary to determine "residence" of foreign ship operators, ascertain their possible liability to tax, and then determine and collect that tax. Procedures would have to be developed, and additional

IRS (or Customs) personnel employed, to determine and assess amounts of tax (small in relation to the efforts involved) ship-by-ship, voyage-by-voyage, and U.S. port-by-U.S. port.

(ii) The increased burden on all foreign shipping companies, both U.S. and foreign owned, of compliance with the new tax provisions.

(iii) Increased ocean transportation costs (in the order of 4%) for goods exported from and imported into the United States, to the extent that the proposed 4% gross basis tax applied to ocean revenues.

(iv) The loss of revenues to the U.S. Treasury, U.S. ports, and local tax authorities from the diversion of vessels and cargoes from U.S. to foreign ports made to avoid application of the proposed new U.S. tax regimen.

The overriding concern of CENSA and ICPL is that adoption of the proposed new rules would undermine a well-established international system of taxation, and by so doing encourage other countries to extend their taxing jurisdictions in conflicting and overlapping ways. The House Proposals would produce a prolonged period of uncertainty and risk of multiple taxation for all foreign and U.S. shipping. The proposed rules would not, we believe, accomplish even the limited objectives for which they are proposed. We respectfully submit that they should not be adopted, in view of the many problems they would create.

ANALYSIS

I. LONG-STANDING U.S. TAX RULES WHICH ACCOMPLISH THEIR OBJECTIVES AND ARE THE BASIS FOR A NETWORK OF INTERNATIONAL AGREEMENTS SHOULD NOT BE CHANGED ABSENT COMPELLING REASONS

Section 883(a)(1) is the keystone of present U.S. tax policy for taxation of foreign shipping income. It exempts from U.S. taxation earnings derived by a foreign corporation from operation of a ship documented under the laws of a foreign country which grants an equivalent exemption to U.S. citizens and corporations. (Section 872(b)(1), the counterpart to Section 883(a)(1), applies to non-resident alien individuals.) This provision was originally enacted in 1921, "[i]n order to encourage the international adoption of uniform tax laws affecting shipping companies, [and] for the purpose of eliminating double taxation." S. Rep. No. 275, 65th Cong., 1st Sess. (1921), 1939-1 (Part 2) C.B. 181, 191. Congress was concerned that varying rules for allocating transportation income in each country in which vessels touched port could result in excessive taxation on shipping, and that if these rules were applied to foreign transportation companies and produced excessive taxation on them, this could produce retaliation against U.S. shipping companies. Congress and the Treasury were also concerned by the complexity in allocating transportation income to the different jurisdictions involved, as well as by the difficulties of collecting any tax due, and the problems inherent in administering such a system. 2/

Congress also addressed itself in 1921 to the rules determining whether transportation revenues should be characterized as U.S. or foreign source income. Prior to 1921, the Treasury took the position that amounts earned on any outbound voyage from the U.S. was income from U.S. sources. See T.D. 3111, 4 C.B. 280 (1920). This rule created problems in the post-World War I shipping market when foreign ships were sent to the U.S. in ballast in order to obtain outbound freight. (The application of the rule frequently resulted in taxing a ship on 125% or more if its actual income from the round trip voyage.) Accordingly, the 1921 Act provided that transportation revenues derived from voyages of foreign vessels

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2/ See, e.g., testimony of Dr. T. S. Adams, Economic Adviser of the Treasury Department, before the Senate Finance Committee, Hearings Before the Senate Finance Committee on H.R. 8245, 67th Cong., 1st Sess., at 47 (1921).

between U.S. and foreign ports were income "partly from sources within and partly from sources without the United States," regardless of where the voyage originated. Section 217(e) of the Revenue Act of 1921 (now Section 863(b)(1)). The Commissioner, with the approval of the Treasury, thereupon promulgated T.D. 3387 in 1922, I-2 C.B. 153, setting forth the rules for allocating transportation service income derived from voyages between U.S. and foreign ports. These rules are virtually identical with those in present Treas. Reg. § 1.863-4, which limit U.S. taxation to voyage income earned while the vessel is in U.S. territorial waters (by applying to gross income the ratio that the expenses incurred and the property used in the U.S. bears to total expenses and property).

Since 1921, a comprehensive network of international reciprocal agreements has been created to govern the taxation of shipping income. According to a 1976 Treasury study, "ships of some 50 countries qualify for exemption from U.S. income tax on the basis of reciprocity; 37 of these exemptions are confirmed in U.S. bilateral income tax treaties." Field and Gordon, "Tax Treatment of Income From International Shipping," Essays in International Taxation: 1976, 75 (U.S. Treasury Department Tax Policy Research Study No. 3). Several observations should be made concerning the Section 883 reciprocal agreements, and the shipping provisions in the tax treaties: (1) there are numerous countries with which the U.S.

does not have treaties, where the Section 883 reciprocal exemption is the only recourse of U.S. or foreign ship operators against double taxation; and (2) the language of each treaty is separately negotiated between the representatives of the two countries involved -- not all treaty shipping provisions are the same, and in many cases established U.S. and foreign shipping arrangements rely not upon the language of a particular treaty, but instead upon the statutory reciprocal exemption provided by Section 883.

The present U.S. regimen respecting taxation of foreign shipping income has accomplished the purposes for which it was intended: it has encouraged the adoption of uniform tax rules affecting U.S. and foreign shipping companies; avoided double taxation and the attendant complexities of trying to allocate shipping income among various U.S. and foreign countries who are potential tax claimants; and has avoided the controversies which would be involved if each country attempted to collect what it regarded as its fair share of such tax. It is not surprising, therefore, that Congress did not adopt the proposals made in 1977 by the Ways and Means Task Force on Foreign Source Income to adopt rules substantially the same as those now proposed.

II. HOUSE PROPOSALS WILL NOT ACCOMPLISH INTENDED PURPOSES

A. Four Percent "Gross Basis" Tax

Supporters of the House proposals contend that the proposed new 4% "gross basis" tax will be helpful in discouraging less developed countries (e.g., Singapore, India, Pakistan and Bangladesh, and possibly other Southeast Asia countries) from levying excise taxes on foreign ship operators using the ports of their countries. The proposed gross basis tax has numerous deficiencies discussed below which are sufficient, in and of themselves, to warrant its rejection. Even assuming none of these problems existed, it is questionable whether the proposed tax could achieve the purpose for which it is intended, for many if not all of the countries at which it is aimed may be retaliation-proof. This is because, as the Ways and Means Report on the House bill recognizes (p. 445), the individual merchant fleets of the developing countries are generally small in comparison with the total fleets of the U.S. and the other foreign countries that enter their ports. The revenues those countries gain from taxing foreign shipping coming into their ports are likely to exceed the additional costs which their own merchant shipping interests (largely government owned) would incur from imposition of similar taxes by the United States or other countries. Accordingly, adoption by the U.S. of a retaliatory tax aimed at these countries may not discourage them from imposing such taxes.

B. Proposed New Source Rule

The proposed new 50-50 source rule, it is suggested, would cure a defect in existing U.S. law whereby only the portion of shipping income attributable to the time foreign ships are actually in U.S. waters is potentially subject to U.S. tax. However, there is no inherent logic, which will necessarily find acceptance by all other shipping countries, to the allocation to the U.S. of 50% of the transportation income from foreign port A to U.S. port B. 3/ A number of jurisdictions use the same source rule used by the U.S. before

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3/ Two special source rules were added by the Tax Reform Act of 1984: a rule treating as 100% U.S. source income transportation income from voyages which both begin and end in the U.S. (even though part of the voyage is outside U.S. territorial waters); and a rule treating as 50% U.S. and 50% foreign source income transportation income from voyages which begin in the U.S. and end in a U.S. possession (or vice versa). Section 863(c)(1) and (2). These rules are not precedents for a general 50-50 U.S./foreign source rule, applicable to all voyages between U.S. and foreign ports. They were enacted to deal with a special problem -- avoidance of the U.S. foreign tax credit limitation by treating as foreign source income (and thus increasing the limitation) amounts which do not have any nexus with any country other than the U.S. (or its possessions). The situations to which these special rules are addressed do not involve the competing claims of other foreign countries to taxation of the same income, and do not involve comparable risks of multiple taxation by several countries such as would be created by a general new source rule, which treated all income from voyages between U.S. and foreign ports as 50% U.S. source income.

1921 -- i.e., they treat the outbound voyage as generating domestic income and the inbound voyage as creating foreign source income (the 1976 Treasury study lists Australia, the Philippines, Indonesia, Malaysia and Singapore as examples -- New Zealand and Hong Kong also apparently follow this rule). Thus, income from a voyage from one of these countries (e.g., Australia) to the U.S. would, if the U.S. were to adopt the proposed 50-50 source rule, be treated as 100% Australian source income and 50% U.S. source income! In addition to this problem, and completely apart from the source rules of the countries just described, suppose a ship, instead of passing directly from a U.S. port to the foreign port of ultimate destination, also passes through the ports and/or territorial waters of one or more other countries, as it is likely to do. What is the basis for saying to these other foreign countries that they have no claim to a share of the tax from the foreign shipment passing through their ports?

The claim of third countries to a portion of the tax is particularly strong in the case of foreign cruise ships, where passengers utilize the port facilities of many countries on any given voyage.

These were precisely the problems Congress and the Revenue Service addressed themselves to in 1921 and 1922, and it was recognized that extension of U.S. claims to shipping income beyond U.S. territorial waters would invite other countries to extend competing tax claims for the same income. The seductive logic of a 50/50 allocation of income is just that -- it ignores the competing claims of other countries and invites the double taxation it seeks to avoid. 4/

C. Proposed Amendment of Section 883

The proposed revision of Section 883 to limit its application to cases where the foreign country providing the reciprocal exemption is the place of "residence" of the foreign ship operator will, it is apparently believed, cure an alleged defect in the present rules which allow foreign ship operators to obtain reciprocal tax exemption by registering ships under the laws of the appropriate flag country, regardless of where the ship operators reside. The proposed amendments to Section 883, however, are unlikely to accomplish any policy objectives, but would only create new problems.

Present Section 883, under which entitlement to the reciprocal exemption turns on whether the country where the ship is registered grants such exemption, is clear and easily administered. Corporations operating foreign ships are

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4/ An arbitrary 50-50 foreign/domestic allocation rule ignores many other factors relevant to a determination of the proper source of the income, such as the location (and costs) of ship management and operations, ship maintenance, crew recruitment and training, etc. Instead, the 50-50 rule places total emphasis on the cargo (or passenger) transportation portion of the operations, ignoring all other elements which are essential to the earning of the income.

frequently owned by persons (or corporations) residing in several different foreign countries. The corporation operating the ships may be incorporated in the country in which some or all (or none) of the owners reside, the ships may be registered under the laws of a country in which some or all of their beneficial owners reside, or under the laws of the country in which their corporation has its place of effective management, or may be registered under the laws of some otherwise unrelated foreign country. The proposed changes to Section 883 would limit the reciprocal exemption to cases where the foreign corporation operating the ship is organized under the laws of a country granting an equivalent exemption to U.S. citizens and corporations, and then only if more than 75% in value of the corporation's stock is owned by persons who are residents either of that country or of another foreign country which grants an equivalent exemption to U.S. citizens and corporations.

Although the language of the House bill and report are unclear on many important points, it is possible that some of the foreign shipping corporations making up the membership of the national shipping associations belonging to CENSA, as well as the member passenger lines of ICPL, could meet the requirements of Section 883 as proposed to be revised (some of these situations are covered by present treaty exemptions). Other member corporations, as presently organized, could probably not presently meet the proposed tests, but might be able to rearrange their corporate structures to do so. Still other member situations would probably not be able to meet the proposed tests because of complexities of their present ownership or financial structures. This could well be the case when ships are operated through consortia -- an increasingly common arrangement -- where the ships may be registered and owned in various countries, and where the shareholders are resident in many different countries. Thus, the proposed changes to Section 883 could possibly be adjusted to in some situations but not in others, and would leave many situations in a state of complete uncertainty as to whether the new rules would or would not apply. This state of affairs would be very disruptive for foreign shipping interests generally (whether U.S. or foreign-owned).

Adoption of the House bill Section 883 "residence" requirement would require detailed and complex statutory and regulatory rules for ascertaining the ultimate beneficial ownership of foreign shipping corporations, and these rules would have to be applied to each foreign shipping situation to determine who the beneficial owners of those corporations are, and where these owners reside. In the case of a corporation with numerous shareholders living in various countries, none of whom control the corporation, this would be a difficult task, creating problems both for the U.S. tax administrators and the foreign shipping interests who attempted to comply with the rules. We submit that this entire exercise is a futile one -- it would create mountains of paper work for the U.S. government and the foreign ship operators without in the end accomplishing any policy objective.

III. EXCESSIVE TAX, ADMINISTRATIVE AND COMPLIANCE BURDENS WOULD BE CREATED BY PROPOSALS

The additional revenues estimated to be raised by the House proposals relating to foreign transportation, even according to the rather optimistic estimates in the House report, are quite small -- $176 million for fiscal 1986, decreasing in subsequent years to the $60-65 million level. These figures do not tell the full story, however, as will be demonstrated below. They ignore off-setting revenue losses; the substantial governmental costs to develop initially and subsequently operate an extremely complex system of tax regulation and collection; the substantial costs of compliance which would be borne initially by ship operators, and which would in turn result in increased shipping charges; and, lastly, they ignore the effects which imposing a tax on gross receipts would have on the shipping industry, which is today severely depressed.

First, it should be emphasized that the proposed 4% gross basis tax cannot be justified as a reasonable approximation of what the U.S. corporate income tax would be if levied on the net income of foreign ship operators. For a 4% tax on gross shipping receipts to be equivalent to what the U.S. corporate income tax would be on net income from foreign shipping operations, the net income from such operations would have to be over 11% of gross receipts! (11% net income times the proposed 36% corporate tax rate equals 4%.) Given the present depressed state of the shipping industry world-wide -- a time of idle ships, foreclosures and other credit problems -- an assumed 11% profitability rate is a dream. Many foreign ship operations are currently being carried on at a loss, and others are at or near the break-even point. Very few come even close to an 11% profitability rate. Thus, the 4% tax on U.S. source shipping income would be confiscatory - a tax on capital, not income.

Second, it is important to remember that to the extent that the 4% gross basis tax does apply, it would result in increased freight rates for goods exported from and imported into the U.S. (applying the same analysis as the 1976 Treasury study referred to above, the increased freight rates reflecting application of the gross basis tax would be in the order of 4%).

Third, the proposed changes would have to be implemented by an elaborate and extensive new system of IRS administrative procedures and personnel. The compliance and enforcement problems are fairly obvious, but the solutions are neither simple nor cheap. In 1984, more than 29,000 foreign vessels entered with cargo into all U.S. ports, and there were more than 28,000 clearances out of U.S. ports with cargo. 5/ These entrances and clearances took place in many different U.S. ports, up and down the East, West, and Gulf coasts of the U.S., and in the Great Lakes. Procedures would have to be developed to determine the "residence" of the beneficial owners of each foreign corporation operating a foreign ship entering or leaving each U.S. port, to ascertain the potential liability to U.S. tax in each case, and if a tax is believed due, to determine the amount of the tax, how and when to collect it, and from whom. (The House bill indicates that the withholding obligation may be imposed on a foreign person, not necessarily present in the U.S., and that a bond may be required in some instances.) All of this would have to be accomplished in some way which would ensure U.S. collection of the tax, and

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5/ Bureau of Census Foreign Trade Report, "Vessel Entrances and Clearances -- 1984 Annual Report," FT 975-84 (August, 1985). Vessels are reported as entered only at the first port at which entry is made, and cleared only at the last port at which clearance is made to a foreign port. Vessels arriving from or proceeding to other U.S. ports are not included, nor are vessels in traffic exclusively between the U.S., Puerto Rico, or U.S. possessions. One reason for the difference between the foreign ship entrance and clearance figures is because the figures are only for ships entering or leaving with cargo, and more ships left the U.S. in ballast than arrived in ballast. In order to apply the proposed new taxing regimen to foreign vessels, both entrances and departures of foreign ships would have to be separately examined to ascertain the amount of tax, if any, believed due, and to arrange for its collection.

accomplish this in a manner which would not unreasonably impede ship departures or cargo clearances! These procedures would certainly require additional government personnel (I.R.S. or Customs or both, depending on where enforcement responsibility was lodged) and would have to be applied ship-by-ship, voyage-by-voyage, and U.S. port-by-U.S. port. Given the relatively minor revenues which would be raised by the proposed tax in any event, the costs of compliance and enforcement -- in terms of additional personnel and paper work -- could well outweigh the additional dollars of tax collected.

The provisions of the proposed new Section 887 (relating to collection of the 4% gross basis tax) would represent a particular difficulty with reference to the obligations imposed on non-resident foreign nationals.

The 4% tax is to be imposed on "the highest amount of U.S. source transportation income that is earned by foreign persons." As illustrated by the example mentioned in the report of the Committee on Ways and Means (House Rep. 99-426, pp. 446-447) foreign nationals would be exposed to a requirement to deduct and withhold the gross receipt tax in connection with transactions between other non-US nationals and themselves. Compliance procedures and costs are a major issue. Ship operators under the protection of tax treaties will face uncertainties regarding the verification of charter contracts for ships chartered-in. There could be legal uncertainties as to the precise implications of contracts of affreightment involving a range of owners with different residences, different degrees of beneficial ownership and different places of effective management. The proliferation of voyage charters by both shipping companies and cargo interests in oil or dry bulk trades would create problems. The liability to be accountable for the 4% tax could give rise to excessive layers of deposits. A commercial inequality could arise in U.S. trades which would cause severe market distortions. The complexity of business transactions would thus place an immense administrative burden on trading with the U.S. This burden would consist of (a) the need to make a determination as to whether the gross tax applies; and if so, (b) to deduct and withhold the applicable tax. The impact of this requirement is extraterritorial in effect and this circumstance has given rise to the expression of concern by the Governments of the Consultative Shipping Group in an aide memoire delivered to the Department of State on February 4, 1986.

Another question raised by the House bill is whether the 4% gross basis tax would apply to 50% of the wages paid to non-resident alien seamen on foreign ships entering or leaving U.S. ports where the foreign ship operator's corporation cannot meet the new residence requirements (and the arrangement is not covered by treaty). Literally reading the House bill language in conjunction with existing Code Section 863(c)(3), it could be argued that the 4% gross basis tax would be applied to 50% of the seamen's wages. This result surely cannot have been intended (the wages are incorporated in shipping charges which are already subject to the 4% tax), and would create horrendous administrative problems and inequities. The problem should be quickly laid to rest.

One way for foreign ship operators to avoid these problems would be to divert cargoes and vessels from U.S. to foreign ports. In the case of cruise liners, this could mean using the Bahamas as a port of arrival and departure instead of Miami. For cargo vessels, this could mean making the port of shipment (or destination) a Canadian port, instead of a U.S. port (leaving it to the U.S. person to get the cargo to or from Canada by truck, train, etc.). To the extent this is done there would be loss of both revenues and employment for local U.S. port authorities and the communities from which passengers and cargoes were diverted.

V. CONCLUSION

The final and fundamental concern CENSA and ICPL have regarding the proposed shipping tax changes is that these changes would undermine a generally accepted international system for taxation of shipping interests without achieving any U.S. (or foreign) policy objectives. Compliance procedures and costs are a major problem, particularly in the case of chartering operations, and the proposals could give rise to commercial inequality in U.S. trades which would cause severe market distortions. We believe that if the U.S. changes the foreign source rules this would encourage other countries to extend their taxing jurisdiction; that other countries might also adopt confiscatory gross receipts taxes (and might not provide for reciprocal exemptions from such taxes); and that there could be a prolonged period of uncertainty and risk of retaliatory taxes levied against foreign shipping generally. This would operate to the great detriment of U.S. as well as foreign ship operators, and we respectfully urge that Congress not embark upon this course.

This material has been prepared jointly by Peter G. Sandlund and Hogan & Hartson, both of Washington, D.C., as agent of and/or legal counsel to CENSA, 30/32 St. Mary Axe, London, England, and ICPL, 74 Trinity Place, New York, New York, U.S.A. Mr. Sandlund's address is 1725 Eye Street, N.W., Washington, D.C., and he is registered under the Foreign Agents Registration Act as Washington, D.C. representative of CENSA. Hogan & Hartson, 815 Connecticut Avenue, N.W., Washington, D.C., is registered under the Foreign Agents Registration Act as an agent of and legal counsel to CENSA and ICPL. This material is filed with the Department of Justice, where the required registration statements are available for public inspection. Registration does not indicate approval of the contents of the material by the United States Government.

STATEMENT OF WILLIAM R. BROWN

President Council of State Chambers of Commerce

Re:Hearings on Tax Reform - February, 1986.

The Committee on State Taxation (COST) of the Council of State Chambers of Commerce consists of some 230 major corporations, largely American owned, but also including some foreign owned companies.

COST strongly urges the Finance Committee to include the substance of the Administration proposal contained in S. 1974, prohibiting imposition by the States of worldwide unitary taxation and restricting State taxation of foreign source dividends, in any major tax revision approved by the Committee this year.

Congress should act on this matter this year in fairness to everybody concerned - both foreign and American - because it is the right thing to do in accordance with accepted international tax procedures and the Constitutional responsibilites of Congress under our Federal-State system. Action this year will also relieve American companies from the very costly imposition of the retaliatory legislation which was approved by the U.K. Parliament in July 1985.

It is essential that provisions along the lines of the foreign source dividend provisions proposed by the Administration be included in any such legislation in order to avoid putting American companies at a competitive disadvantage with their foreign competitors who would be relieved of State worldwide unitary taxation. A competitive advantage would result because the foreign owned companies' dividends are substantially exempt from taxation in most domiciliary countries either by exclusion from taxable income or by means of a tax credit and would also not be subject to State taxation, as would American owned companies unless Congress approves provisions along the lines of the "equitable taxation" provisions proposed by the Administration.

We hope that the Finance Committee will schedule a hearing at an early date on S. 1974. At such time the Council's Committee on State Taxation will be pleased to present testimony in support of the major provisions of S. 1974 and make some suggestions for improving it.

We look forward to working with the Committee and staff on this matter which is of extreme importance not only to American and foreign business, but also the American and foreign governments.

Cranford Woodcarving, Inc.
330 19TH STREET S.E.
P. O. BOX 2426
HICKORY, N. C. 28601
(704) 328-4538

February 11, 1986

The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Bldg.
Washington, D. C. 20510

Attn: Betty Scott-Boom

The House-passed version of tax reform is anti-growth and anti-jobs. I urge the Senate to set aside tax reform for now, and turn its attention to the nation's twin-deficits-spending and trade.

Thank you for your attention to this matter.

Very truly yours,

CRANFORD WOODCARVING, INC.

Terry Cranford
President

TAC/js

Cressona Aluminum Company

Cressona, Pennsylvania 17929-1299
(717) 385-5000
Telex No 847464

February 19, 1986

The Honorable Robert Packwood
Chairman
Senate Committee on Finance
219 Russell State Office Building
Washington, D.C. 20510

Dear Mr. Packwood:

The purpose of this letter is to express opposition to the passage of HR 3838, The Tax Reform Act of 1985, and I ask that my message be included in the hearing record for HR 3838.

Cressona Aluminum Company is a company that I believe would be considered part of "smokestack America". A group of private investors purchased this idled plant seven years ago after it had been abandoned by Alcoa. We now have over 600 employees and have never laid off anyone since we started up in May of 1979. In April 1984 we purchased a second facility in Farmersville, Texas. If Cressona Aluminum is to continue to be successful it is essential that we continue to spend substantial amounts of money to modernize and update our forty year old plant and equipment at Cressona as well as our facility in Texas.

My reason for objecting to HR 3838 is that, without the business investment incentives, we will not be able to maintain our growth or expand, making it more difficult to compete with the ever-growing foreign competition. The loss of these incentives will result in this nation being placed at a very serious competitive disadvantage with foreign imports. And we must not let that happen. It is essential that America maintain a strong foundation of basic industry if we are to return to a sound economy.

The elimination of the deficit and the return of fiscal responsibility to the management of federal spending is the most crucial problem facing our nation. However, I feel strongly that this tax bill is anti-business and will be harmful to not only our company but to our nation as well.

Sincerely,

James M. Stine

James M. Stine
President

cc: Honorable J. John Heinz, III
Honorable Arlen Specter
Honorable Gus Yatron
National Association of Manufacturers

STATEMENT OF THE
DELTA DENTAL PLANS ASSOCIATION
TO THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

February 7, 1986

Mr. Chairman, Members of the Committee:

This statement is respectfully submitted on behalf of the more than 15 million subscribers to prepaid dental benefit plans that are made available by this country's nonprofit dental service corporations. Such corporations are chartered in, and regulated by, 42 states, the District of Columbia and Puerto Rico, and all of them are members of the Delta Dental Plans Association (DDPA).

Along with other nonprofit organizations which provide prepaid health benefits to millions of Americans, the DDPA members are concerned that removal of the long-standing tax exemption conferred by Section 501 (c)(4) of the Internal Revenue Code as proposed in H.R. 3838 will have serious ramifications which were not subjected to public hearings or otherwise given adequate consideration prior to the action taken by the House of Representatives. The DDPA greatly appreciates the recognition of this fact by the Committee and its willingness to examine and analyze the consequences of this fundamental change in time-tested tax policy.

By way of background, it is important to note that in the early 1950s the first Delta Dental Plans on the Pacific Coast were the pioneers of prepaid dental care in the United States. At that time, commercial insurers had no interest in insuring dental services because the risks were unknown, and therefore unmeasurable, and the profit potential was too uncertain for companies owned by investors or policy holders.

Only after nonprofit dental service plans had demonstrated for several years that work-place coverage of dental benefits was a viable venture, did the commercial, profit making insurance companies enter the field. Today such companies sponsor plans covering approximately 85 million beneficiaries as compared to approximately 15 million by nonprofit plans, showing clearly that the federal tax exemption has not diminished competition, but in fact has helped create and promote competition.

Additionally, nonprofit dental service plans have taken the initiative in offering many community programs that have not been seriously considered by commercial insurance companies. For example, in several states, DDPA plans have contracted on an "at risk" basis to provide dental care to the states' Medicaid eligible populations. "At risk" means that the state pays a fixed monthly price per eligible person to obtain all dental services covered by the Medicaid program. This form of contract has benefited the states and Medicaid beneficiaries by assuring predictability in budgeting, as well as improved dental care at stable cost. In the first such program in California, the Delta Dental Plan in that state and the state's dentists (who participated in risk sharing) lost $8 million in the start-up year. No commercial insurance company was prepared to take that kind of risk; in fact, no commercial insurance company ever has been a serious bidder for this type of program. Only a nonprofit organization primarily interested in improvement of public health is willing to take the risks involved in innovative ventures of this kind.

Currently, and looking to the future, many DDPA member plans are experimenting with new, innovative methods of extending prepaid dental care to segments of the population that are now not well served such as retired people, the self-employed and others. Again, commercial insurers have not served these types of beneficiaries because the financial results are too uncertain. There is no doubt that if nonprofit health plans succeed again in demonstrating the fiscal viability of these new types of coverages, those companies that must show a profit for their investors will follow and provide healthy competition.

Innovative and genuine concern for public health require financial backing. Nonprofit health plans need reasonable financial reserves in order to be able to take risks. These reserves are created by income that, in for-profit organizations, would be used to provide a return to investors and to pay taxes. If this income is taxed, the ability to build these reserves is reduced, and in order to survive and pay the same taxes as commercial insurers, the present nonprofit health plans will have to compete on the same terms.

The result of the weakening or elimination of nonprofit health plans inevitably will be higher health care costs for the consumer, reduction of "high risk" services, or a combination of both. Those who ultimately pay new taxes on nonprofit health plans are likely to be those whose health care needs are already least served, because they are "high risk" -- the poor, the elderly, and people who do not belong to well-organized, large groups. These are the ones who can least afford price increases, but to whom the cost of taxes is most likely to be shifted. Disproportional shifting to these groups is likely because there is little competition for their business and because profit oriented companies will not find service to high risk groups and individuals to be a high priority.

Also noteworthy is the fact that nonprofit dental service corporations initiated and continue to operate under unique contract arrangements with providers which encourage and reward prevention of disease, require quality controls and result in long-term cost savings and improved health for beneficiaries.

The foregoing are among the many reasons we believe that nonprofit health plans have earned and continue to deserve tax exempt status.

Finally we would point out that the proposed removal of the tax exempt status of nonprofit dental service plans would have, at most, a negligible effect on federal tax revenues but could seriously limit the ability of such plans to continue to compete in the interest of the public.

D

DePaulUniversity

Office of the President

25 East Jackson Boulevard
Chicago, Illinois 60604

February 17, 1986

Senate Finance Committee
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman & Members of the Committee:

As President of DePaul University, an Independent Illinois College Institution located in Chicago and having an enrollment of approximately 13,000 students, I respectfully request that your committee reject several dangerous provisions of HR3838 (the Tax Reform Act of 1985).

More specifically, I am very concerned with those provisions of this bill which undermine the tax exempted status of the pension plans of most of the colleges and universities of this country, in particular, the pension plans provided by the Teacher's Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF).

In general, the attack of the house bill on these pension plans is a public signal that our federal government no longer accords the respect and financial encouragement which for many years have counterbalanced the financial sacrifices made by very talented women and men to serve in key teaching and research roles. There is even sericus grounds to charge the house bill with unfair discrimination against the faculties and staffs of higher education in that other types of non-profit institutions are not faced with the undermining of their tax exempted status.

Section 1012 of HR3838 taxes both the colleges and the persons now benefitting from TIAA-CREF pension and insurance assets. While a very substantial restructuring of this system could avoid, or at least minimize, the proposed taxes, this very restructuring would place a heavy penalty on the institutions and persons.

Section 1113 of the bill would place severe administrative burdens on colleges and universities. This is directly contrary to the admirable steps the Congress and Administration have recently taken to reduce the heavy burden of bureaucratic paperwork already imposed on these institutions.

I find section 1102 objectionable in that it places new restrictions on the amount of tax exempt salary production an employee can make toward his/her retirement plans. Section 1101 has a similar discouragement for university employees. Section 1123 introduces a new tax penalty for college personnel who begin drawing from their tax deferred annuity accumulations before the age of 59 1/2.

In view of the deleterious effect these provisions of HR3838 would have on college personnel and their institutions, I urge the members of the Senate Finance Committee to reject these provisions.

Sincerely yours,

Rev. John T. Richardson, C.M.
President

JTR CM:ct

EASTERN MICHIGAN UNIVERSITY
OFFICE OF THE PRESIDENT

February 18, 1986

Senate Finance Committee:

I am writing to express our opposition to several provisions of the Tax Reform Act of 1985 (H.R. 3838) recently passed by the the U.S. House of Representatives and about to be considered by the U.S. Senate. These provisions would be very disruptive to the retirement planning of employees of nonprofit institutions like Eastern Michigan University. I am most concerned about the detrimental consequences to employees at this institution if the bill passes in its present form. In my opinion, the most harmful provisions of H.R. 3838 are the following:

- Section 1012 of the bill withdraws the tax exemption of pension plans provided by the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF). TIAA-CREF pension plans have been tax-exempt for more than 65 years, and taxation of these plans will have the effect of reducing retirement benefits to some 1,000,000 active and retired employees and their spouses. One of the major inequities of this legislation is that the the pension plans of nonprofit institutions would lose their tax exemption, while those of labor unions, business corporations and governments would remain untaxed.

YPSILANTI, MICHIGAN 48197
(313) 487-2211

As I am sure you realize, salaries for staff members throughout the educational community are considerably lower than compensation for individuals in the private sector. Many educators have elected to stay in nonprofit employment because they believe that teaching and education are vital to our nation's current and future well-being. To single out TIAA-CREF pensions for discriminatory tax treatment is unduly harsh. Such a proposal raises serious questions as to why this form of retirement savings suddenly warrants taxation after more than 65 years of existence.

- Section 1102 of the House Bill would impose a new lower limit of $7,000 on employee salary reduction contributions to retirement and tax-deferred annuity plans. The new limit severely restricts the ability of many to save additional amounts for retirement. I ask that this provision be amended so that required employee retirement plan contributions made via salary reduction are not included in the $7,000 limit.
- In addition, under section 1101, the $2,000 maximum Individual Retirement Account contribution would be reduced by one dollar for each dollar contributed by salary reduction. In practice, this provision would effectively eliminate the use of an IRA by many persons, because any IRA contributions made would then be limited by a combined IRA and salary reduction amount to only $2,000.

- Section 1123 of the bill requires that a 15% penalty tax be assessed against withdrawals from tax-deferred annuity accumulations resulting from contributions made before December 31, 1985, unless the individual making the withdrawals is over age 59½, becomes disabled, or dies. One of the most unfortunate consequences of the 15% tax penalty is that it acts as a regressive tax on employees in lower tax brackets. These employees would lose a proportionately higher share of their funds, should they have to pay this penalty tax, than would an individual in a higher tax bracket, since the higher tax bracket individuals receive a greater percentage decrease under the tax reform bill than those in lower brackets.

The new provisions also change the rules under which tax-deferred annuity contributions made in previous years are treated. These existing assets are subject to the same additional tax provisions of H.R. 3838 as future contributions -- an unusual approach that goes against the traditional legislative philosophy that subsequent law should not punish behavior permitted under former law. Had such additional taxes been envisioned, many would have made retirement savings arrangements based on the greatest degree of access to their funds.

I question why Congress would so thoroughly discourage those who work in education or research to save for their retirement. Although this is probably an unintended consequence of the legislation, there may be other unintended effects. Consider that restricting the ability of these persons to save for retirement could place additional pressure on the Social Security system and increase their dependence on the government. Also, limiting their ability to make contributions to pension plans like TIAA-CREF could reduce the level of U.S. capital formation, since these funds are a direct and major source of new investment capital to business and industry.

Let me also add my support of the House of Representatives' resolution that the effective dates of the above provisions in H.R. 3838 should be changed to January 1st of the calendar year following the year in which the bill is signed by the President.

Clearly, it is difficult, if not impossible, to create tax reform legislation that pleases everyone. However, as you are called upon to exercise your judgment on the bill's various provisions, please be aware of the foregoing considerations, all of which will have major adverse effects on a sizable number of your constituents -- and on the national interest, because talented people in education and research will lose a large measure of their ability to prepare for a financially secure retirement.

Thank you for your attention and consideration.

Sincerely,

John W Porter

John W. Porter
President

cc: Senator, Donald W. Riegle
Senator, Carl M. Levin

STATEMENT BY
THE EDISON ELECTRIC INSTITUTE
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE
FEBRUARY 14, 1986

The Edison Electric Institute (EEI) appreciates the opportunity to submit this statement regarding capital formation incentives and H.R. 3838, the Tax Reform Act of 1985, for the record of the hearings held January 29 and 30 and February 4, 5, and 6, 1986.

EEI is the association of electric companies. It members serve 96 percent of all customers served by the investor-owned segment of the industry. They generate approximately 75 percent of all electricity in the country and provide electric service to 73 percent of the nation's electricity customers.

EEI supports reform of the Internal Revenue Code to achieve fair and equitable taxation of individuals and businesses. However, we are seriously concerned about the long-term effects of tax-reform proposals that would reduce capital-formation incentives because this industry is the most capital intensive industry in the United States. Reducing capital-formation incentives increases the cost of capital which in turn increases the the cost of electricity to customers thus increasing the cost of goods and services produced in the United States.

Electric Utility Capital Formation

EEI's member companies currently have some $340 billion of utility plant. In 1986, approximately $30 billion will be paid by EEI member companies to investors and creditors for the use of their capital. While most other industries invest less than a dollar to obtain a dollar of sales, the investor-owned electric utility industry invests $2.89 for each dollar of sales.

For more than 30 years, the Internal Revenue Code (Code) has provided capital-formation incentives. These incentives have contributed to the growth of our nation's economy and have contributed also to capital formation within the electric utility industry. The Committee Reports that accompanied the legislation in which capital-formation incentives were provided addressed very clearly the reasons for their establishment. In summary, these reasons are increased economic growth, improved productivity, additional jobs and increased international competitiveness. From the standpoint of both the national economy and the electric utility industry, capital formation is a valid objective of tax legislation.

Capital-Formation Attributes of Tax-Reform Legislation

Set forth below are attributes of tax reform legislation that would contribute to capital formation. These attributes will be discussed more fully in the context of the Tax Reform Act of 1985 (H.R. 3838) later in this testimony.

Cash Flow - Capital-formation incentives, in order to accomplish their purposes, should contribute to cash flow. Accelerated depreciation with shorter lives for tax purposes in comparison with book straight-line depreciation can be a major contributor to cash flow. The present value of the depreciation deductions should be a significant percentage of the cost of the original investment. For example, EEI is of the opinion that the depreciation system contained in the President's tax-reform proposals would encourage capital formation. Other methods that would increase cash flow and reduce capital costs are appropriate also.

Inflation - Depreciation should be indexed for inflation to partially compensate for inflation as a "tax" on capital and to allow businesses to build a pool of capital for replacement investment. Here again, the President's proposals met this criterion.

Normalization - There is not a beneficial cash flow effect for regulated industries unless normalization of the effect of capital-formation incentives is required by law for regulated industries. If normalization is not required, then regulatory agencies are free to immediately flow through these benefits to customers, and the expected cash flow from the capital-formation incentives is lost. With immediate flow through, the capital-formation incentives merely become a subsidy to the current customers while the cost of electricity is increased for future customers.

Investment Neutrality - One type of investment should not be favored over another type of investment as a result of tax provisions. In other words, there should be equality in the competition to sell goods and services and to attract capital.

Transition Rules - Transition rules should, among other matters, be designed to avoid the loss of capital-formation incentives that could occur as a result of the shift from one set of tax laws to another. In the case of electric utilities, much of their property is constructed over periods as long as 15 years. Tax law changes, in particular those in connection with depreciation and the investment tax credit (ITC), should not adversely impact companies that made decisions to construct or continue construction in reliance on prior laws. This "transition window" period should afford long construction lead-time utility property the necessary time to take advantage of the capital-formation incentives of current law so that long-ago investment decisions would not be adversely affected. A six-year transition period was provided when the ITC was repealed in 1969, and EEI believes that a similar transition period would be appropriate as part of the current tax reform efforts. Many electric utilities that would be affected by onerous transition rules are those companies already experiencing financial difficulties because of necessary construction programs. These companies need the protection of transition rules against changes to the Code enacted subsequent to those investment decisions.

Under current law, ITC's are allowed on "qualified progress expenditures" (QPE's) for property that normally takes more than two years to construct. Taxpayers are permitted to take ITC's and QPE's on their returns each year as amounts are expended. Electric utilities have utilized this provision with respect to the construction of nuclear and conventional generating plants, major transmission lines and sub-stations.

Without the appropriate transition rules, failure to place electric utility property in service by a stated date would cause a recapture (i.e. repayment to the Government) of ITC's and QPE's previously taken for all prior years. This may be called the "cliff effect" because if the property is not placed in service by the deadline, a retroactive denial of all prior QPE ITC's results. This would adversely affect consumers because the ITC is shared with customers through the rate-making process. A transition rule should provide that ITC's and QPE's not be subject to recapture even though the related property is not placed in service prior to the deadline date.

The provision for ITC transition rules adopted in H.R. 3838 recognizes the long construction lead-time problems associated with electric facilities. This provision does not, however, cover delays in the regulatory process that are beyond the control of the affected utility, which may face the loss of QPE ITC's for reasons beyond its control. While the House has made a significant stride forward in adopting progressive transition rules, additional language should be included in any final legislative language to ensure that regulatory delays "toll" the running of the "transition window" period. Such an improvement over the House proposal would ensure that utilities would not be denied credits for reasons beyond their control.

Tax-Exempt Bond Financing - Under present law, "pollution control facilities" and "facilities used for the local furnishing of electric energy," constructed or acquired by public utilities, are permitted to be financed with so-called "private purpose" industrial development bonds within the limits of state "caps". This type of financing has provided an economic method of financing pollution control facilities which essentially are not installed to produce income but are constructed strictly for the protection of the environment. The use of "private purpose bond financing" for facilities used for the local furnishing of electric energy permits privately-owned public utilities to compete with the tax-exempt financing available to municipally-owned electric companies. Moreover, it has provided a means for lower cost financing to be used to reduce the high cost of electric energy for the customers in qualifying areas.

We believe this limited ability to utilize industrial development bond financing for facilities used in our industry should be retained in the law, especially inasmuch as such financing would come within the state-by-state limitation on "private purpose" bonds.

H.R. 3838

The capital formation provisions of H.R. 3838 possess some of the attributes set forth in the preceding section of this testimony as capital formation criteria. EEI appreciates that the House of Representatives provided the following:

- Required normalization for regulated companies
- Transition rules for depreciation and the investment tax credit
- Partial inflation indexation
- Ten percent dividends paid deduction
- Absence of excess depreciation recapture provisions
- "Grandfathering" of pre-1986 qualified progress expenditures from recapture
- Net operating loss provisions in connection with use of ITC credits under the alternative minimum tax
- Use of the alternative minimum tax liability as a credit against the regular tax liability

On the other hand, H.R. 3838 would reduce or eliminate to a great extent other important capital-formation incentives. The provisions that could have a significant negative impact on electric utilities are:

- A significant reduction in depreciation benefits
- Repeal of the investment tax credit
- Capitalization, in place of expensing, of certain costs where a taxpayer produces property
- Introduction of a corporate alternative minimum tax
- Elimination of tax exemption for certain private purpose bonds
- Inclusion in gross income of contributions in aid of construction
- Repeal of five-year amortization of pollution control facilities

EEI estimates that in the first year, the internal generation of funds by investor-owned electric utilities would be reduced $2 billion (1984 dollars) annually, as a result of H.R. 3838. In the year 2000, internal generation of funds will be reduced by about $9 billion annually, or almost 40 percent of internal generation. Replacement of these lost funds would have to be provided by investors, which would increase the costs of producing electricity and the price paid by customers. Furthermore, these calculations do not include the impacts of the minimum tax. Consideration of the proposed minimum tax in the study could reduce further internal generation of funds.

A study by Emil Sunley, former Deputy Assistant Secretary of the Treasury, demonstrates the severe attrition that H.R. 3838 would have on capital formation incentives. He calculated the effective tax rate on the capital invested in the property of electric utilities that would result from H.R. 3838. The study's methodology was designed to demonstrate the impact of specific tax provisions on the taxes of the capital of an industry based on a typical industry investment. This has been coupled with the regulatory treatment of that investment. The real effective tax rate under H.R. 3838, with five-percent inflation, would approximate 49.7 percent for a fossil-fueled generating plant and, with 10-percent inflation, would approximate 59.5 percent. As the statutory corporate rate would be 36 percent under H.R. 3838 as compared to the higher effective tax rates calculated in the study, this demonstrates the lack of capital formation incentives under the bill. Only when the effective tax rate is below the statutory rate is an incentive provided. Thus, H.R. 3838 would provide a disincentive to invest. This disincentive would serve to increase the cost of capital and lead to an increase in the cost of electricity. EEI is also concerned that the depreciable life of transmission and distribution equipment would be increased to 30 years under H.R. 3838. EEI believes that this long life is not equitable and does not reflect an appropriate depreciable life for this property.

The President's tax reform proposals were designed to combine support for capital formation with tax reform. Generally, under the President's proposals, all property (except for real property and inventory) would have an effective tax rate of 18 percent compared to the statutory rate of 33 percent, a true incentive for capital formation. The President's proposals were also predicated on neutral tax treatment of many investments because property in classes 1 through 5 would have the same effective tax rate. EEI believes this is a worthy goal of tax reform.

A tax system which achieves investment neutrality is advantageous because it assists in the capital formation process by making the allocation of capital more efficient. With many industries in competition for capital, capital allocation and the attendant costs should not be disproportionately influenced by the tax system. The President's tax-reform proposals would make significant strides toward investment neutrality.

Neutrality of investment incentives is important to electric utilities and their customers because of increased competition to provide energy. Competition is experienced from oil, gas, alternative energy sources (sun, wind, biomass), and cogeneration and small power producers. Generally, under current tax law, these competitors now receive more favorable tax treatment than do investor-owned electric utilities. This preferential treatment would be continued under most tax-reform proposals. Effective tax rate studies confirm this discrimination against public utility property. Paul Craig Roberts testified before this Committee last year with respect to discrimination in the tax law against regulated industries. He stated that:

> "Utilities: Regulated public utilities would receive a long overdue redress of the discrimination shown over the past decades in tax law. This industry has repeatedly been

> assigned longer tax lives for the same assets owned by other industries. The administration's proposal corrects this, and utility assets are conformed to all other industries. The net result is a smaller increase in this industry's cost of capital than would be experienced by other equipment-intensive industries."

Remedies

In order to remedy the capital-formation problems that would be created by H.R. 3838, EEI recommends the following changes:

- Depreciation - Adopt the President's proposed Capital Cost Recovery System (CCRS). Alternatives to CCRS are to shorten the depreciable lives contained in H.R. 3838, to accelerate the depreciation method and to design a depreciation system that would treat investments in a neutral manner.
- Alternative corporate minimum tax - Revise H.R. 3838 to:
  - Create a greater differential between the alternative minimum tax rate of 25 percent and the regular corporate income tax rate of 36 percent.
  - Allow investment tax credits generally to be used as a credit against the alternative minimum tax so that the value of this capital formation incentive may be realized.
  - Do not include depreciation of personal property other than of personal property covered by any new depreciation system as a preference item. If the

current law's depreciation of personal property became a preference item, this capital-formation incentive would effectively be retroactively reduced.

o Capitalization of certain expenses where a taxpayer produces property - H.R. 3838 requires the capitalization of certain construction period expenses rather than allowing them as a current deduction. If this provision were to be enacted it should recognize that both debt and equity are used to finance a project. For regulated industries, only the debt expense attributable to the project in accordance with the formula applied by the Federal Energy Regulatory Commission and other regulatory agencies should be required to be capitalized. Similar rules could be formulated for unregulated industries.

o Industrial development bond financing - H.R. 3838 retains tax-exempt bond financing in a limited manner for certain of the facilities qualifying for such financing under present law. The House bill does not, however, include "pollution control facilities" or "facilities for the local furnishing of electric energy" within the defined group of facilities eligible for financing by "non-essential function bonds."

There would appear to be no reason why pollution control facilities and facilities for the local furnishing of electric energy, to be constructed or acquired by public utility companies, should not be included in the group of facilities eligible for financing by "non-essential function bonds". The addition of these facilities to the group of qualifying facilities would not lead to any increase in tax-exempt bond financing as such "non-essential function bonds" are strictly controlled by the unified state volume limitations which provide a state-by-state annual limit on all such financings included in the group. Thus, each state could make its own rules and determinations as to which projects it would approve within its "cap".

- Decommissioning costs of a nuclear power plant - Amend section 468A of the Code, even though not addressed in H.R. 3838, in a manner similar to that offered by Representative Sam Gibbons in H.R. 1619 to permit a deduction for amounts which are to be used to decommission a nuclear power plant if they are either deposited in a separate fund as required by current law, or recorded in an unfunded reserve. By permitting a utility to record these amounts in an unfunded reserve and use them to finance facilities, a utility may have the opportunity to provide greater earnings on the amounts than by investing them in the open market. Representative Gibbons' bill also provides that earnings on amounts placed in separate funds be taxed at one-half the maximum corporate rate rather than the maximum rate as under current law. The effect of such changes would reduce the cost of electricity to our customers.

- Contributions in aid of construction - This provision requires the inclusion as gross income of contributions by customers of the utility to assist with construction of facilities. It should be recognized that customer contributions in aid of construction are treated for ratemaking purposes as contributions to the capital structure of a utility and are not income. The electric utility industry has long relied on this nontaxable feature to allow installation of facilities which should not be charged to all other customers or to allow the provision of service to rural customers where the incremental cost of installing the equipment has been held to a minimum by way of this provision. The repeal of section 118B of the Code would increase the cost of installation and equipment by almost 30-40 percent and thereby reduce the current reliability of electric service. To institute taxation of these previously nontaxable contributions could seriously deter business growth, raise the cost of energy and create a further impediment to an expanding economy.

Impacts on the Electric Utility Industry

EEI strongly believes that the significant reduction of capital formation incentives resulting from H.R. 3838 would increase the cost of capital of electric utilities. In addition, the EEI testimony of October 3, 1985 to this Committee addressed the need for new construction to meet future electricity demand. Once the requirement for new generating plant has been established by a company, tax provisions can assist in capital formation. As explained herein, H.R. 3838 would significantly reduce capital formation incentives for electric utilities and would add to the other major disincentives to build electrical generating plant that many electric utilities have been experiencing in the 1980's, e.g., the inability to adequately recover their investment or to earn an adequate return on investment. The lessened electric supply reliability that our nation or various regions could well experience would, in turn, have a deleterious effect on the nation's economy.

National Economy

A reduction of capital formation incentives would hamper the expansion of the national economy. One of the goals of tax reform is to stimulate economic growth. If that goal cannot be met, much of the rationale for tax reform is lost. Capital-formation incentives should not be reduced unless it can be demonstrated clearly that the overall economy would not be damaged.

There is less incentive for capital formation in H.R. 3838 than in current tax law. Among other commentators, Yolanda Henderson, a visiting scholar at the American Enterprise Institute, in an article entitled "Investment Incentives Under the Ways and Means Bill" has confirmed this. She calculates that the overall effective corporate tax rate would be 41.5 percent under H.R. 3838 as compared to 31.1 percent under current law and the proposed statutory rate of 36 percent.[1] Thus, because of the virtual absence of capital- formation incentives, the effective tax rate would be higher than the statutory rate. Tax rates are one of the determinants of investment decisions. Assuming all other determinants (e.g., interest rates, inflation) are held equal, it is probable that there would be reduced investment compared to current law if H.R. 3838 were enacted.

---

[1] Yolanda K. Henderson, "Investment Incentives Under the Ways and Means Tax Bill," Tax Notes, December 9, 1985.

EEI has compared the return on equity during the period 1980 to 1985 of capital intensive industries that are most in need of capital-formation incentives to the returns of less capital intensive industries. Relatively high inflation was experienced during a portion of this period. The results show that, generally, industries with higher levels of capital requirements had lower returns on equity. A table of the comparisons is attached as Appendix A. Capital intensive industries need the assistance of capital-formation incentives to overcome the disadvantage of being capital intensive so that investment in their assets is encouraged and capital costs are reduced.

Finally, there are two reasons from the standpoint of international competitiveness as related to electric utilities that capital-formation incentives should not be impaired. Some regions in the U.S. are importing electricity generated in foreign countries because of lower prices. Lessening of capital-formation incentives could exacerbate this dependence on foreign energy. Furthermore, any increase in the price of electricity, such as would occur as a result of reduced capital-formation incentives, would be reflected in the price of U.S. products and would reduce the nation's international competitiveness.

Summary

EEI believes that preservation of capital-formation incentives to stimulate economic growth is a necessary goal of tax reform and should be given high priority in the Senate

Finance Committee's deliberations. Within the electric utility industry, capital-formation incentives ultimately serve to reduce the cost of electricity to customers, thereby contributing to growth and international competitiveness.

Thank you for the opportunity to present our views.

Appendix A

COMPARISON OF RETURN ON EQUITY AND CAPITAL INTENSITY BY INDUSTRY

Industry	5-Year Return on Equity - %	Capital Intensity Rank
Beverages	22.4	11
Tobacco	20.3	13
Petroleum	18.9	9
Toiletries and Cosmetics	18.5	12
Computers	17.4	6
Food Processing	16.0	16
Supermarkets	15.9	17
Aerospace	15.8	14
Apparel	15.2	15
Electric Utilities	13.6	1
Railroads	12.2	2
Chemicals - Diversified	12.3	10
Paper and Pulp	11.2	7
Office Equipment	10.8	4
Metal and Mining	8.6	3
Steel	6.3	5
Airlines	1.6	8

Source: Return on Equity - *Forbes Magazine*, January 14, 1985
Capital Intensity - *Business Week*, March 22, 1985.

ELECTRICAL EQUIPMENT
COMPANY

RICHMOND, VA.
SOUTH HILL, VA.
FRANKLIN, VA.
RALEIGH, N.C.
LAURINBURG, N.C.
AUGUSTA, GA.

1807 Boulevard West
Post Office Box 27327
Richmond, Virginia 23261

(804) 353-7841

Richard L. Hedgepeth
President

1966

February 10, 1986

Hon. Mack Mattingly
United States Senate
c/o Senate Post Office
B17 Dirksen Senate Office Building
Washington, D. C. 20510

Dear Senator Mattingly:

As a small business with plants located in Virginia, North Carolina and Georgia, we would appreciate your efforts in setting aside the tax reform as covered by HR 3838, as we perceive it to be irreparably flawed. Rather, let us concentrate our energies and efforts on the nation's twin deficits -- spending and trade.

Please include the above comments in the written Finance Committee hearing record.

Sincerely yours,

Richard L. Hedgepeth
Richard L. Hedgepeth

RLH/bhc

ELIZABETHTOWN COLLEGE
ELIZABETHTOWN, PENNSYLVANIA 17022

Office of the President

February 18, 1986

Senate Finance Committee
Committee on Finance, Room SD-219
Senate Dirksen Office Building
Washington, DC 20510

Gentlemen:

On behalf of the active and retired employees of Elizabethtown College who are participants in the Teachers Insurance and Annuity Association and the College Retirement Equities Fund (TIAA-CREF), I wish to voice support for the retention of (TIAA-CREFF's federal tax exemption under consideration by the Senate Finance Committee.

As stated by James G. MacDonald, Chairman and Chief Executive Officer of TIAA-CREF at the Senate Finance Committee hearings on H.R. 3838 on February 4, 1986, termination of tax exemption for the TIAA-CREF pension system would be unfair and would reduce benefits for participants.

Participating institutions, and particularly small, private institutions such as Elizabethtown, rely on the tax exempt status of TIAA-CREF in providing for the retirement of faculty, administrative and staff personnel. To tax the TIAA-CREF program while exempting virtually all other pension funds strikes us as not only unfair, but discriminatory toward the 3,600 non-profit educational institutions across the United States.

Monies received from the TIAA-CREF pension funds are often vital to retired participants who must rely on them to help meet the obligations of other taxes, mortgages, rentals, and the daily costs of living. TIAA-CREF does not stand to gain any advantage over other types of pension funds through a continuation of its exempt status, but those who depend on it for their retirement surely stand to lose if Section 102 of H.R. 3838 becomes law.

Elizabethtown College stands in full support of Mr. MacDonald's statements before the Committee, and the position of TIAA-CREF.

Sincerely,

Gerhard Spiegler

Gerhard E. Spiegler
President

GS/pr

STATEMENT OF

JAMES W. ROUSE

CHAIRMAN OF THE BOARD

THE ENTERPRISE FOUNDATION

February 21, 1986

Before the

Committee on Finance

United States Senate

The Enterprise Foundation
505 American City Building, Columbia, Maryland 21044
(301) 964-1230

SUMMARY OF COMMENTS AND RECOMMENDATIONS

I. Current Situation

II. Private Sector Response

III. The Enterprise Foundation

IV. Case Examples of Impact of Tax Reform Proposals

V. Proposal for Targeted Use of Existing Tax Incentives

VI. Analysis of House Tax Revision Bill

VII. Conclusion

STATEMENT OF JAMES W. ROUSE
BEFORE THE
COMMITTEE ON FINANCE
UNITED STATES SENATE

FEBRUARY 21, 1986

Mr. Chairman:

I am pleased to submit the following statement on the Tax Reform Act of 1986. My statement deals primarily with the impact of the proposals for tax reform on private sector initiatives for housing the very poor.

I. CURRENT SITUATION

The 1980 census shows that 42 percent of the 13 million families making less than $10,000 per year were paying over 50 percent of their income for rent, often for substandard housing. The situation is worse today as gentrification, abandonment and demolition continue to reduce housing stock available to the poor. Rents increase yearly; incomes of poor people do not increase as rapidly as the cost of living. Thus, increasing numbers of families are falling below the poverty line.

Additionally, with the termination of many federal programs, including the Section 8 Rental Assistance Payments Program, and the proposed sharp cutbacks in all types of assistance for low-income housing, available federal resources for addressing the housing needs of the very poor are being eliminated.

The Reagan Administration has issued a challenge to the private sector for creative solutions, for individual and local initiatives to solve, at the local and state levels, the difficult housing problems of the poor.

II. PRIVATE SECTOR RESPONSE

The Enterprise Foundation, along with several other private sector non-profit organizations, has responded. We are working with non-profit neighborhood housing groups across the country to provide technical and financial assistance to rehabilitate the available housing stock for low-income families.

The Enterprise Foundation has stimulated corporate and other private sector participation in non-profit housing rehabilitation in distressed neighborhoods in the heart of American cities through the use of existing tax incentives for low-income housing. This aggressive new campaign, just recently launched, is making possible very low-cost rehabilitation through investment of corporate funds not previously available for housing the poor. Most of these neighborhood projects have no ongoing federal subsidies and are being built as lowest-cost rehabilitations with substantial amounts of private money invested, usually with the commitment of a corporation concerned with social responsibility.

To understand the importance of existing tax incentives for low-income housing and their effectiveness in leveraging private sector commitments to a national need, one must understand the working of The Enterprise Foundation.

III. THE ENTERPRISE FOUNDATION

Organized in 1982 as a national non-profit publicly supported charitable organization, The Enterprise Foundation set out to form a new national system of non-profit neighborhood-based groups dedicated to helping the very poor help themselves to decent, livable housing and out of poverty and dependence into self-sufficiency.

Enterprise has a distinguished Board of Trustees drawn from business, government and housing experts, including:

Lisle C. Carter, Jr.	Former President, University of the District of Columbia
N. Gordon Cosby	Minister, The Church of the Savior, Washington, D.C.
Mathias J. DeVito	Chairman of the Board and President, The Rouse Company
Cushing N. Dolbeare	Former President, The National Low-Income Housing Coalition
Coy Eklund	Former Chairman, Equitable Life Assurance Society of the United States
The Honorable John W. Gardner	Former Secretary of HEW
Samuel Gary	Chairman, Gary-Williams Oil Producer
W. H. Krome George	Former Chairman, Aluminum Company of America
Ronald Grzywinski	Chairman, Executive Committee, South Shore Bank of Chicago

BEST COPY AVAILABLE

Ernest W. Hahn	Chairman of the Board, Ernest W. Hahn, Inc.
Andrew Heiskell	Vice Chairman, The Brookings Institution
Jing Lyman	National Director, HUB Program for Women's Enterprise
The Honorable Robert S. McNamara	Former President, The World Bank
Louis E. Martin	Assistant Vice President for Communications, Department of University Relations, Howard University
Leeda Marting	General Partner, Communication Ventures
The Honorable Charles McC. Mathias, Jr.	U.S. Senator from Maryland
Milton J. Petrie	Chairman, Petrie Stores Corporation
The Honorable Henry S. Reuss	Former Chairman, House Committee on Banking, Finance and Urban Affairs; Former Chairman, Joint Economic Committee
James W. Rouse	Chairman, The Enterprise Foundation, Chairman, The Enterprise Development Company
Patricia T. Rouse	Board Member, World Times, Inc., Mediators Productions, Inc.
Andrew C. Sigler	Chairman, Champion International Corporation
Alexander B. Trowbridge	President, National Association of Manufacturers
Raul Yzaguirre	President, National Council of La Raza
Barry Zigas	President, National Low Income Housing Coalition

The Foundation has raised over $25 million from individuals, corporations and foundations to support its work.

It is building from the bottom up -- at the neighborhood level -- a national system to house the poor. It is currently operating in 24 cities with 54 non-profit neighborhood groups. Enterprise helps these groups restore their communities by rehabilitating substandard housing and by providing human services, such as job placement centers, health care facilities and crime prevention units.

Enterprise works with neighborhood groups to reduce housing rehabilitation costs and forge partnerships with local business and city governments. It helps obtain low-rate financing and provides small seed money grants and low-interest loans -- "linchpin" money -- to tie together other resources into a housing rehabilitation package.

To cut housing rehabilitation costs, Enterprise formed the Rehabilitation Work Group, a panel of experts in every aspect of housing rehabilitation. This part of the Foundation works with the neighborhood groups to review systematically the plans, processes and budgets of housing projects. We have achieved a 20 to 40 percent reduction in rehabilitation costs in most cities.

The Enterprise Social Investment Corporation ("ESIC") was formed to bring in private investment and fund low-rate financing for housing the very poor. ESIC has developed programs for existing low-income housing using tax incentives heretofore largely neglected by non-profit groups, and has tapped corporate investments in restoring non-profit sponsored housing rehabilitation for the very poor.

In all its efforts, the Foundation is developing new ways to harness the creativity and disciplines of the free enterprise system to encourage the initiative and effort of neighborhood groups. It is adapting self-help programs that work in its network of neighborhood groups and finding ways for corporations and other private sector groups to participate in a responsible, meaningful way.

Also, Enterprise is now working with a southern city to establish a larger model of a city-wide public/private partnership that will eliminate all unfit housing in that city over a period of 10 years.

There is a further involvement of the private sector. The Enterprise Foundation has set up a wholly-owned for-profit taxable subsidiary, The Enterprise Development Company, which works in inner city commercial development, creating jobs, spurring urban economic development and affording opportunity for minority merchants. In its first four projects, festival marketplaces located in the heart of Norfolk, Toledo, Flint and Richmond, over 4,000 new jobs have been created, more than a third filled by previously unemployed people and more than 48 new minority-owned small businesses have been created. These projects have attracted large crowds to downtown areas, exceeded all previous sales per square foot records in the area, and directly contributed to new downtown development in these cities. New projects are being completed in Battle Creek and Baltimore and are planned in Philadelphia, Pittsburgh, Hartford, Orlando and other cities. All profits will flow back to the Foundation and out to housing for the poor.

IV. CASE EXAMPLES OF IMPACT OF TAX REFORM PROPOSALS

We are deeply concerned, however, about the impact of the tax reform proposals now before the Finance Committee on the rehabilitation of housing for the poor. Many of the Foundation housing developments base their financing structure upon the use of existing low-income tax incentives, particularly Section 167(k) five-year amortization of qualified rehabilitation costs. In all cases, private resources, including limited partner investment by corporations and individuals, mortgages financed by banks, savings and loans, and insurance companies, and second mortgages by The Enterprise Foundation or other charitable organizations, comprise the bulk of the financing.

Without the availability and use of the tax incentives which attract equity investors to provide approximately 20-25 percent of the financing requirements, the rehabilitation could not meet the needs of the poor. Nor would other private sector resources be available on comparable terms, as the use of debt instead of equity money in the transaction, even if available, would significantly increase the housing costs to the poor.

For instance, in a partnership formed between the non-profit Cleveland Housing Network and SOHIO to rehabilitate low-income housing, SOHIO will make an equity investment which will contribute to the rehabilitation costs and for which it will receive tax benefits. The City of Cleveland will contribute a corresponding amount of low-interest second mortgage money, and a local bank will provide the first mortgage.

The rehabilitated single-family houses will rent for $180 per month during the period of the 15-year partnership and may be sold at the end of that period to the low-income tenant, as currently allowed under Section 167(k).

The Cleveland Housing Network, as general partner, will implement a social service and advocacy program for the tenants, including six-month inspections of the properties with the right to evict those who do not properly maintain their houses. This non-profit coalition of nine housing groups is making a major impact upon the poorest neighborhoods in Cleveland.

Involvement of the private sector is possible through the raising of "equity money" in return for tax incentives generated over the life of the partnership and through leverage of this "equity money" to induce other bank or financial institution participation. The example cited is one of many now being entered into with major corporations. This marks the first time corporations have taken a direct role in neighborhood housing for low-income families.

V. PROPOSAL FOR TARGETED USE OF EXISTING TAX INCENTIVES

We at The Enterprise Foundation and other sponsors and supporters of urban and rural revitalization efforts believe that targeted exceptions or incentives should be made part of any tax reform legislation.

Certain provisons should be included in any new tax legislation to preserve or create incentives for housing for the very poor if they meet narrowly-defined criteria designed to insure maximum cost-effectiveness relative to lost tax revenues. Accordingly, we strongly recommend that existing low-income housing incentives be preserved for low-income rental rehabilitation or new construction projects where syndication proceeds are used either in the project itself, or for new low-income rehabilitation or new construction projects.

In effect, such criteria would allow tarteted tax treatment for cost-effective projects largely financed by the private sector and consistent with national policy. Thus, we ask for projects meeting such criteria, the following:

a. Retention of the five-year deduction (Section 167(k)) for rehabilitation expenses incurred in low-income housing rehabilitation;

b. Retention of the "at risk" exception for low-income housing;

c. Retention of the current accelerated depreciation formula for low-income housing costs;

d. Retention of preferential capital gains treatment for low-income housing;

e. Retention of existing investment interest limitation and alternative minimum tax treatment for limited partner investors who invest in low-income housing; and

f. Retention of current deductions for construction period interest and taxes on low-income housing development.

VI. ANALYSIS OF HOUSE TAX REVISION BILL

Members of the House Ways and Means Committee recognized the need to keep tax incentives for low-income housing. In 1985 homeowners benefited from over $38 billion of tax savings, primarily through mortgage interest deductions, while less than $1 billion was used as tax incentives for very low-income rental housing. Furthermore, direct Federal low-income housing subsidies have been severely cut and the need for affordable housing has greatly increased, while tax reform measures bring the prospect of severe rent increases or complete unavailability of any affordable housing. The House Ways and Means Committee acted to encourage the efforts of the private sector in low-income housing rehabilitation and new construction through continuing limited low-income tax incentives.

However, due to the complexity of the multiplicity of tax reform changes and the nature of low-income housing financing, three major provisions of the House Bill make the low-income tax incentive designated for housin the poorest largely unusable. First, the minimum tax provisions classifying low-income housing along with other partnership losses as tax preference items, make the sale of those losses of marginal value. Low-income housing generates substantial losses using accelerated depreciation, the principal tax incentive provided by Congress, and has little or no cash flow and little property appreciation. Thus, tax losses are its incentive value. The proposed minimum tax provisions would, in most cases, remove any incentive for the private sector to invest.

Secondly, since commercial financing is often unavailable at rates which will make housing for the poorest affordable, extention of the at-risk rules to real estate "purchase money" loans for low-income projects would hurt the typical financing structure for low-income housing partnerships. Furthermore, without the availability of favorable seller financing, most existing low-income property syndications cannot be resold without conversion to market rents, removing critically needed supply from the very poor.

Finally, in our financings, like those of similar organizations, homeownership is an important component of our rehabilitation and new construction programs. Typically, at the end of the lease or rental period, working with our neighborhood groups, we will provide that responsible tenants may assume ownership. The extension of real estate depreciation lives and the increase in capital gains tax rates for donated property increases the amount of taxes due on a sale of property to the tenants or a donation to a charitable organization, and thus reduces any incentive for private investors to participate such homeownership programs.

A simple solution to these and other technical difficulties, particularly in light of Congress' commendable intentions of eliminating tax abuses while also meeting a critical need in housing, is to quantify the current intended tax incentive for low-income housing rehabilitation and new construction, and provide it in the form of a refundable or nonrefundable tax credit, much like the rehabilitation tax credit. In a simplified manner, through a tax credit, Congress can directly target what it intends -- removing the complexities and inefficiencies of the tax law while encouraging the private sector to produce more low-income housing.

VII. CONCLUSION

We strongly recommend that the Senate Finance Committee either retain the current tax law for low-income housing tax incentives or enact a targeted refundable or non-refundable tax credit at the 20% rate, similar to the proposed rehabilitation tax credit for historic buildings. We have enclosed certain other specific recommendations on H.R. 3838's provisions regarding low-income housing proposed by the National Low Income Housing Coalition, with which we concur.

Without this federal assistance, housing rehabilitation or new construction programs for the poor will proceed at a negligible pace, and the current housing crisis will worsen. Many, including the Administration, recognize the problem, yet it is hard for the private sector to assume the burden without any help from the Federal Government. Working together through a reasonable package of tax incentives, we can begin to deal with the huge task ahead -- meeting the housing needs of the very poor in a cost effective, sustainable manner.

Thank you.

Ernst & Whinney

1225 Connecticut Avenue, N W
Washington, D C 20036

202 862-6000

December 9, 1985

Republican Leadership of the U.S.
House of Representatives, and

Republican Members of the Committee
on Ways and Means
U. S. House of Representatives
Washington, D. C. 20515

We have reviewed the attached comparative analysis of allowed itemized deductions and taxable income by family size under the Republican Alternative and the Ways and Means Committee Bill for 1987, assuming itemized deductions are at 20% and 30% of adjusted gross income.

The Ways and Means Committee Bill has reference to the provisions of H.R. 3838, which was introduced in the House of Representatives on December 3, 1985. The Republican Alternative has reference to the substitute proposals offered as an amendment to H.R. 3838, and reported beginning on page H-11305 of the Congressional Record of December 6, 1985.

Given the assumptions set forth in the attached analysis, we have concluded that the analysis accurately sets forth the impact of H.R. 3838 and the Republican Alternative to the amounts of allowed itemized deductions and taxable income in the described factual situations.

Very truly yours,

Ernst & Whinney

Attachment

Comparison of Allowed Itemized Deductions and Taxable Income by Family Size Under Republican Alternative and Ways and Means Bill (assuming Total Itemized Deductions are 30% of Adjusted Gross Income) for 1987

Family Size	Income Level	Total Itemized Deductions	Itemized Deductions Allowed After Standard Deduction: Ways & Means Bill	Itemized Deductions Allowed After Standard Deduction: Republican Alternative	Taxable Income: Ways & Means Bill	Taxable Income: Republican Alternative
4	20,000	6,000	0	538	7,200	6,862
5	20,000	6,000	0	538	5,200	4,862
6	20,000	6,000	0	538	3,200	2,862
7	20,000	6,000	0	538	1,200	862
4	25,000	7,500	700	1,748	11,500	10,652
5	25,000	7,500	200	1,748	10,000	8,652
6	25,000	7,500	0	1,748	8,200	6,652
7	25,000	7,500	0	1,748	6,200	4,652
4	30,000	9,000	2,200	2,958	15,000	14,442
5	30,000	9,000	1,700	2,958	13,500	12,442
6	30,000	9,000	1,200	2,958	12,000	10,442
7	30,000	9,000	700	2,958	10,500	8,442
4	35,000	10,500	3,700	4,167	18,500	18,233
5	35,000	10,500	3,200	4,167	17,000	16,233
6	35,000	10,500	2,700	4,167	15,500	14,233
7	35,000	10,500	2,200	4,167	14,000	12,233
4	40,000	12,000	5,200	5,304	22,000	22,096
5	40,000	12,000	4,700	5,304	20,500	20,096
6	40,000	12,000	4,200	5,304	19,000	18,096
7	40,000	12,000	3,700	5,304	17,500	16,096

Comparison of Allowed Itemized Deductions and Taxable Income
by Family Size Under Republican Alternative and Ways and Means Bill
(assuming Total Itemized Deductions are 30% of Adjusted Gross Income) for 1987

			Itemized Deductions Allowed After Standard Deduction		Taxable Income	
Family Size	Income Level	Total Itemized Deductions	Ways & Means Bill	Republican Alternative	Ways & Means Bill	Republican Alternative
4	45,000	13,500	6,700	6,417	25,500	25,983
5	45,000	13,500	6,200	6,417	24,000	23,983
6	45,000	13,500	5,700	6,417	22,500	21,983
7	45,000	13,500	5,200	6,417	21,000	19,983
4	50,000	15,000	8,200	7,530	29,000	29,870
5	50,000	15,000	7,700	7,530	27,500	27,870
6	50,000	15,000	7,200	7,530	26,000	25,870
7	50,000	15,000	6,700	7,530	24,500	23,870
4	75,000	22,500	15,700	13,095	46,500	49,305
5	75,000	22,500	15,200	13,095	45,000	47,305
6	75,000	22,500	14,700	13,095	46,500	45,305
7	75,000	22,500	14,200	13,095	42,000	43,305
4	100,000	30,000	23,200	18,660	64,000	68,740
5	100.000	30,000	22,700	18,660	62,500	66,740
6	100,000	30,000	22,200	18,660	61,000	64,740
7	100,000	30,000	21,700	18,660	59.500	62,740

Comparison of Allowed Itemized Deductions and Taxable Income by Family Size Under Republican Alternative and Ways and Means Bill (assuming Total Itemized Deductions are 30% of Adjusted Gross Income) for 1987

Assumptions used in preparing Comparison of Allowed Itemized Deductions and Taxable Income

1. Total itemized deductions are 30% of adjusted gross income.

2. Total itemized deductions are divided into the following categories:

   46% Personal mortgage and consumer interest (20% of which is assumed to be non-mortgage, non-educational interest subject to the $1,000 cap under the Republican Alternative).

   40% State and local taxes (10% of which is assumed to be sales and personal property taxes which are not allowable as deductions under the Republican Alternative).

   8% Charitable contributions.

   6% Other deductions.

3. The standard deduction assumed for the Ways and Means Bill (H.R. 3838) is the 1987 amount of $4,800. The standard deduction assumed for the Republican Alternative is the 1986 amount of $4,600, unadjusted for inflation.

4. The standard deduction is assumed to be $2,000 and is not adjusted as provided under the Republican Alternative for taxpayers with a marginal tax rate greater than 25%.

Comparison of Allowed Itemized Deductions and Taxable Income by Family Size Under Republican Alternative and Ways and Means Bill (assuming Total Itemized Deductions are 20% of Adjusted Gross Income) for 1987

			Itemized Deductions Allowed After Standard Deduction		Taxable Income	
Family Size	Income Level	Total Itemized Deductions	Ways & Means Bill	Republican Alternative	Ways & Means Bill	Republican Alternative
4	30,000	6,000	0	538	17,200	16,862
5	30,000	6,000	0	538	15,200	14,862
6	30,000	6,000	0	538	13,200	12,862
7	30,000	6,000	0	538	11,200	10,862
4	35,000	7,000	200	1,345	22,000	21,055
5	35,000	7,000	0	1,345	20,200	19,055
6	35,000	7,000	0	1,345	18,200	17,055
7	35,000	7,000	0	1,345	16,200	15,055
4	40,000	8,000	1,200	2,151	26,000	25,249
5	40,000	8,000	700	2,151	24,500	23,249
6	40,000	8,000	200	2,151	23,000	21,249
7	40,000	8,000	0	2,151	21,200	19,249
4	45,000	9,000	2,200	2,958	30,000	29,442
5	45,000	9,000	1,700	2,958	28,500	27,442
6	45,000	9,000	1,200	2,958	27,000	25,442
7	45,000	9,000	700	2,958	25,500	23,442
4	50,000	10,000	3,200	3,764	34,000	33,636
5	50,000	10,000	2,700	3,764	32,500	31,636
6	50,000	10,000	2,200	3,764	31,000	29,636
7	50,000	10,000	1,700	3,764	29,500	27,636

Comparison of Allowed Itemized Deductions and Taxable Income
by Family Size Under Republican Alternative and Ways and Means Bill
(assuming Total Itemized Deductions are 20% of Adjusted Gross Income) for 1987

Family Size	Income Level	Total Itemized Deductions	Itemized Deductions Allowed After Standard Deduction: Ways & Means Bill	Itemized Deductions Allowed After Standard Deduction: Republican Alternative	Taxable Income: Ways & Means Bill	Taxable Income: Republican Alternative
4	75,000	15,000	8,200	7,530	54,000	54,870
5	75,000	15,000	7,700	7,530	52,500	52,870
6	75,000	15,000	7,200	7,530	51,000	50,870
7	75,000	15,000	6,700	7,530	49,500	48,870
4	100,000	20,000	13,200	11,240	74,000	76,160
5	100,000	20,000	12,700	11,240	72,500	74,160
6	100,000	20,000	12,200	11,240	71,000	72,160
7	100,000	20,000	11,700	11,240	69,500	70,160

Comparison of Allowed Itemized Deductions and Taxable Income
by Family Size Under Republican Alternative and Ways and Means Bill
(assuming Total Itemized Deductions are 20% of Adjusted Gross Income) for 1987

Assumptions used in preparing Comparison of Allowed Itemized Deductions and Taxable Income

1. Total itemized deductions are 20% of adjusted gross income.

2. Total itemized deductions are divided into the following categories:

   46% Personal mortgage and consumer interest (20% of which is assumed to be non-mortgage, non-educational interest subject to the $1,000 cap under the Republican Alternative).

   40% State and local taxes (10% of which is assumed to be sales and personal property taxes which are not allowable as deductions under the Republican Alternative).

   8% Charitable contributions.

   6% Other deductions.

3. The standard deduction assumed for the Ways and Means Bill (H.R. 3838) is the 1987 amount of $4,800. The standard deduction assumed for the Republican Alternative is the 1986 amount of $4,600, unadjusted for inflation.

4. The standard deduction is assumed to be $2,000 and is not adjusted as provided under the Republican Alternative for taxpayers with a marginal tax rate greater than 25%.

Statement of the Federal Managers Association
before the Senate Finance Committee
on Tax Reform
February 1986

The Federal Managers Association strongly opposes the inclusion of the provision changing the tax treatment of retirement annuities for Federal employees, Members of Congress, and their staffs in the Tax Reform Bill.

Sec. 1122 (c) of H.R. 3838 changes the tax status in the distribution of Federal retirement annuities as of June 30, 1986. Because of this change, a significant number of Federal workers in key positions, WORKERS WHO HAVE NOT PLANNED TO RETIRE but are eligible to retire, WILL LEAVE GOVERNMENT SERVICE at the beginning of June.

The House Ways and Means Committee estimated that this change will bring in $8 billion in revenue in the first 5 years. THIS IS A SHORT-SIGHTED APPROACH:

> In 12 years, the revenues from this provision will be a complete wash. The government will not have one cent of increased revenue at the end of that time period.
>
> No one has figured out how much it will cost the government to pay out retirement benefits to the people who will leave prematurely because of this provision, nor how much it will cost to replace the people who leave.
>
> Under current law, the government gets a very good deal. Taxes are levied on income which employees do not even begin to receive for decades. The government has full use of those revenues throughout that period and they are deposited in the general fund. The current situation, then, is immediate taxation on deferred income. While employees willingly accept this immediate taxation on deferred income, we oppose a further deferral on already taxed dollars far beyond retirement.

The Federal Managers Association urges you to remove from the Tax Reform Bill the provision that can cause serious problems with the delivery of services in this country.

It is important to note that these people who will be forced to retire are, in many instances, the top talent at an agency. They are the people with the expertise and experience necessary to run the government efficiently. We cannot afford to let them leave.

It has been estimated that we could lose up to 25% of our Federal work force in one month:

Our National Defense could be compromised.

Mail delivery could be seriously impaired.

Our Air Traffic Control system could be put into chaos.

Social Security checks could be delayed.

Research projects in health and science areas could be in jeopardy.

The FMA polled its members regarding this provision and found some interesting results:

3924 supervisors and managers polled

2152 (55%) eligible to retire

599 (28%) WILL RETIRE

In specific agencies, the numbers can run higher. In our FAA Air Traffic Control Chapters, the results are:

823 polled

395 (48%) eligible to retire

224 (57%) WILL RETIRE

We urge you to consider carefully the consequences of this change and to oppose its inclusion in the Senate's tax reform legislation.

David W. Sanasack
Executive Director

F

Feldkircher
WIRE FABRICATING COMPANY, INC.

P.O. BOX 4570 • 1015 W. KIRKLAND • NASHVILLE, TN 37216 • TELEPHONE 615/262-0471

February 6, 1986

Attn: Betty Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Bldg.
Washington, D.C. 20510

Re: Tax Reform Bill H.R 3838

Chairman, Packwood

I understand that the Senate Finance Committee is currently holding hearings regarding tax reform bill H.R. 3838. I would like to submit to your committee my own comments regarding this bill and request that these comments be included in your hearing record.

I feel that the House-passed version of this bill is adverse to the growth of industry in this country and to decreasing unemployment. I urge the Senate to focus its attention on the more pressing matters of the national debt and trade deficit, and postpone tax reform for now.

I appreciate the opportunity to present my comments on this matter

Sincerely,

M.L. Wakefield

M.L. Wakefield
President

cc: Senator Jim Sasser
Senator Albert Gore Jr.

Plants in Hartsville and Nashville

STATEMENT OF
THE FINANCIAL ANALYSTS FEDERATION
SUBMITTED TO
COMMITTEE ON FINANCE
UNITED STATES SENATE

February 6, 1986

Introduction:

The Financial Analysts Federation is the professional organization for security analysts, investment managers and others in the investment decision-making process, with 15,600 members in the United States and Canada. Members are directly and indirectly involved in the investment of more than three trillion dollars of U.S. funds. The Federation offices are at 1633 Broadway, New York, NY 10019. The phone number is 212/957-2860.

This statement to the Senate Committee on Finance has been prepared by the Federation's Government Relations Committee, which is chaired by Walter S. McConnell, CFA, of Houston, Texas. Mr. McConnell is a principal in the investment counsel firm of Vaughan, Nelson, Scarborough, and McConnell, Inc. He is a past chairman of the Financial Analysts Federation.

The Federation appreciates the opportunity to participate in the deliberations of the Finance Committee by submitting the comments below. Hundreds of the Federation's members specialize in the analysis of specific industries such as machinery, chemicals, health care and office automation. If the Committee on Finance would care to discuss the impact of any part of the proposed legislation on a particular industry with these specialists, we would be glad to make the arrangements. Such specialists, we believe, would be among your most knowledgeable and objective sources of information.

Capital Formation:

The focus of our statement is on capital formation. As much as any other factor, the capital formation process will determine the long-term growth of the economy, the rate of job creation, our success in controlling inflation and our ability to compete with foreign producers in both overseas and domestic markets.

The different proposals to change the tax code now being considered would have a varying impact on capital formation. Lower tax rates on individual and business incomes and especially on capital gains would influence saving and investment in a positive way. Lower rates should improve the efficiency of the process, moreover, as investments are made more for economic reasons and less for tax reasons. On the other hand, elimination of the investment tax credit and a slowing in the rate of depreciation write-offs would reduce returns on investment and limit the flow of funds generated internally by business. The net effect on capital formation necessarily will depend on the mix of proposals finally adopted.

Capital Gains:
Further we consider it particularly important that the tax rate on capital gains be further reduced. A tax differential on capital gains increases the rewards for entrepreneurship and risk taking - and it is risk investment that will best stimulate growth and enable us to compete with the Germans and Japanese as well as with South Korea and the other low-wage, emerging industrial nations of the Pacific Basin.

Venture capital investment has expanded sharply since the maximum tax rate on capital gains was cut to 28% in 1978 (from 49%) and to 20% in 1982. According to Venture Economics, the net volume of new private capital committed to venture-capital firms rose to an average of $1.9 billion a year in 1978-84 from only $53 million in 1971-77.[1] Part of this increase came from the easing of pension-trust investment rules in 1979. At the same time, though, capital commitments by domestic taxable accounts (individuals and families, corporations, and insurance companies) averaged $735 million a year in 1979-84, or 14 times the total funds from all sources in the 1971-77 period before tax rates were reduced. Because lower taxes increase the potential reward from investment, there is every reason to think that investment would rise further if the tax rate on capital gains were reduced again.

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[1] Reported in Workbook of Fourth Annual Government-Business Forum on Small Business Capital Formation, Securities and Exchange Commission, September 1985.

A lowering of capital gains taxes also would improve the mobility of capital through the "unlocking" effect on investments held at low cost. This would facilitate the flow of funds to the fastest-growing areas of the economy, which is an essential function of a free market.

Another consideration is that a majority of our major industrial trading partners do not tax capital gains.[2] Of ten leading industrial countries, Japan, West Germany Italy, Belgium, The Netherlands and Australia have no effective tax on this form of income. Long-term capital gains are taxed at lower rates than ours in France and Canada and at higher rates only in the United Kingdom and Sweden. This difference in treatment may well translate into a long-term competitive disadvantage for U.S. companies and workers, particularly in high-risk businesses.

Meanwhile, a reduction in capital gains rates should not have to be "paid for" through a loss of revenues to the Treasury. In 1978 the Treasury estimated that the pro-

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2. Comparision of Individual Taxation of Long and Short Term Capital Gains on Portfolio Stock Investments and Dividend and Interest Income in Eleven Countries. New York, Securities Industry Association and Arthur Andersen & Co., June 1983.

posed reduction in rates would reduce revenues by several billion dollars. In practice, revenues from capital-gains taxes rose from $8.1 billion in 1977 to $12.9 billion in 1982, as a doubling of realized gains more than offset a decline in the effective tax rate.[3] Preliminary indications are that revenues rose by a meaningful further amount in 1983.

Tax rates cannot, of course, be reduced again and again without eventually having a negative effect on receipts, but the experience since 1978 indicates that revenues are at least as likely to go up as to go down if the tax rate on capital gains is reduced from 20% to 17.5%. In contrast to its position in 1978, the Treasury has estimated that such a rate reduction would be approximately revenue neutral. A recent study by the National Bureau of Economic Research, meanwhile, suggests that maximum revenues would be generated with the top tax rate on capital gains below the current 20% level.[4]

Reduced Tax Rates on Individuals and Corporations: We also support the proposed reduction in basic tax rates for individuals and corporations. For individuals, lower tax rates - and especially lower marginal tax rates - would encourage work, savings and investment. Lower rates also would reduce the incentives for tax avoidance and uneconomic allocation of resources. Because of these special effects, a reduction in basic rates would have more beneficial influence on capital formation than would an increase in personal exemptions. For corporations, lower rates would improve returns and therefore make new investment more attractive.

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[3] Capital Gains in Adjusted Growth Income, Total Captial Gains and the Effective Tax Rate on Capital Gains (1954-1982) for Returns with Net Capital Gains. Washington, D.C., Office of the Secretary of the Treasury, Office of Tax Analysis, March 5, 1985.

[4] Estimating the Revenue - Maximizing Top Personal Tax Rate. National Bureau of Economic Research Working Paper No. 1761, Lawrence Lindsey, Cambridge, Mass, 1986.

Retirement Plans:

The provision for individual retirement accounts (IRAs) begun in 1975 has been quite successful, with this pool of investment funds now amounting to $197 billion.[5] A substantial portion of these funds, moreover, apparently represents "new" savings as opposed to money that would have been saved in another form.[6] This program also serves a valuable social purpose by making retirees less dependent on public assistance. The proposal to expand the "spousal" contribution extends both of these benefits and we support this proposal. On the other hand, the proposed limitation on 401 (k) contributions would restrict the availablity of investment funds. Although

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5. Estimate for December 31, 1985 by Investment Company Institute, Washington, D.C.

6. IRAS: The People's Choice: A National Survey of Individual Retirement Account Investment Practices and Preferences. Washington, D.C., The Research Department, Investment Company Institute, February 28, 1985, pages 46-49.

the sums involved are small, we consider this a step backward insofar as capital formation is concerned.

Capital Cost Recovery:

We have mixed views regarding the proposals to eliminate the investment tax credit and make depreciation write-offs less generous. We recognize that these changes would generate large volumes of revenues to be used to finance tax reductions in other parts of the code. We also agree that lowering business tax rates is preferable to subsidizing particular industries (through such devices as the investment credit) since this would relieve Congress of the task of setting industrial policy.

On the other hand, we question the wisdom of shifting a major portion of the tax burden from individuals to business. In theory, the increase in taxes will be passed back to individuals - through higher prices, lower wages or reduced returns to shareholders. The mechanism is complicated, however, by the growing importance of foreign producers in the market place.[7] Equipment write-offs already are faster in most other industrial economies, and the proposed lengthening of the write-off period for domestic companies would worsen this competitive disadvantage. Given the fragile state of the basic industry portion of our economy, we suggest that depreciation write-offs be curtailed by a smaller amount than is currently being proposed.

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[7] Study of the Relationship Between Liberality of Tax Write-off Provision and Certain Measures Related to the Rate of Capital Investment. New York, The Financial Analysts Federation, January 1980.

Revised

Capital Gains in Adjusted Gross Income, Total Capital Gains and the Effective Tax Rate on Capital Gains (1954-1982) for Returns with Net Capital Gains

Calendar years	Gains in adjusted gross income	Excluded gains 1/	Total gains	Estimated taxes paid on capital gains income	Estimated effective tax rate
	(...............$ millions			.....................)	(percent)
1954	3,732	3,425	7,157	1,010	14.11%
1955	5,126	4,755	9,881	1,465	14.83
1956	4,991	4,692	9,683	1,402	14.48
1957	4,128	3,982	8,110	1,115	13.75
1958	4,879	4,561	9,440	1,309	13.87
1959	6,797	6,340	13,137	1,920	14.62
1960	6,004	5,743	11,747	1,687	14.36
1961	8,291	7,710	16,001	2,481	15.51
1962	6,821	6,630	13,451	1,954	14.53
1963	7,468	7,111	14,579	2,143	14.70
1964	8,909	8,522	17,431	2,482	14.24
1965	11,069	10,415	21,484	3,003	13.98
1966	10,960	10,388	21,348	2,905	13.61
1967	14,594	12,941	27,535	4,112	14.93
1968	18,854	16,753	35,607	5,943	16.69
1969	16,078	15,361	31,439	5,275	16.78
1970	10,656	10,192	20,848	3,161	15.16
1971	14,559	13,782	28,341	4,350	15.35
1972	18,397	17,472	35,869	5,708	15.91
1973*	18,201	17,556	35,757	5,366	15.01
1974*	15,378	14,839	30,217	4,253	14.07
1975	15,799	15,104	30,903	4,535	14.67
1976*	20,207	19,285	39,492	6,621	16.77
1977	23,363	21,974	45,337	8,104	17.88
1978	26,232	24,294	50,526	9,348	18.50
1979	31,331	42,112	73,443	11,669	15.89
1980	32,723	41,859	74,582	12,459	16.71
1981	34,713	46,225	80,938	12,684	15.67
1982	38,514	51,639	90,153	12,900	14.31

Office of the Secretary of the Treasury
Office of Tax Analysis

March 5, 1985

1/ 1954-1977: One-half of (net long-term gains - net short-term loss) for those with net gains.

*The excluded gains are estimated.

(Form 60)

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Flint Ink
CORPORATION

United States Senate
Committee on Finance
Washington, D.C. 20510

Re: H.R. 3838
Hearings to be held
January 29 & 30
February 4,5 & 6

Profit sharing plans have existed in one form or another for more than 100 years and they were originally conceived as a way of correcting some of the social injustices caused by the Industrial Revolution.

Through the years, profit sharing plans have evolved into one of the single most important benefits an employee can have. They fulfill a unique role in the broad spectrum of benefits offered to employees of U.S. business organizations. Profit sharing plans provide supplemental cash when an employee severs his relationship with the employer but more importantly, profit sharing plans provide for the welfare of a widowed spouse if an employee should die unexpectedly. In addition, profit sharing plans provide retirement and disability benefits that help supplement social security benefits, as social security alone is woefully inadequate.

As was pointed out in an article by the Employee Benefit Research Institute profit sharing, more than any other benefit, often is seen as having an incentive value to the employer as well as the employee. A profit sharing plan raises employees' consciousness about the importance of and the need for profits causing them to work harder and more effectively and to enhance the success of the business enterprise. Isn't that what American free enterprise is all about? Aren't we all striving to keep American business strong? Legislate away the employee incentive and you could irrevocably destroy American business and allow for a national welfare state.

CORPORATE HEADQUARTERS • 25111 GLENDALE AVENUE • DETROIT, MICHIGAN 48239-2689
Telephone (313) 538-6800 Telex 23-1133

Profit sharing programs are multi-motivational because they focus the attention of all on a common target - increased profits - and then reward all factors of production with profit participation. The rewards of higher profits and the penalties of low profits are shared proportionately by all contributing factors.

Profit sharing plans definitely assist us in our national quest for greater productivity and non-inflationary distribution of the fruits of our labor. Profit sharing plans satisfy a national need both as an organizational incentive to improve corporate efficiency and as a flexible reward mechanism to share efficiency goals.

With the passage of ERISA in 1974 came the introduction of Individual Retirement Accounts, an opportunity to allow individuals to assist the government in providing for the retirement years. With the passage of the Tax Reform Act of 1978 came the introduction of 401(k) plans which build upon the theory of allowing individuals the opportunity to help fund their retirement. Funding of IRA's and 401(k)'s on a "pay as you go" formula provides a marvelous opportunity for individuals to increase retirement earnings while perhaps reducing the pressure that is being exerted on the social security system. IRA's and 401(k)'s give employees the extra purchasing power when they need it most: at retirement.

Retirement plans are social as well as organizational benefits and the provisions of these plans must be kept. To do away with them through legislation means doing away with social and organizational incentives and the next stop is, if not a welfare state, then at the very least, tremendous pressure upon the Social Security System.

The Flint Ink Corporation Profit Sharing and Benefit Plan was established on December 1, 1951. The Plan was created for the exclusive use and benefit of present and future employees of the Corporation. Flint Ink Corporation is desirous to promote in its employees the strongest interest in the operation of the business, loyalty to the Corporation, increased efficiency in their work, and the assurance that the employee will share in the prosperity of the enterprise.

The Flint Ink Profit Sharing Plan is a contributory plan. That is to say that in order to participate, eligible employees must contribute a portion of their salary or wages. Today, of the approximately 1,100 eligible employees 1,090 are participating.

From January 1, 1982 to June 30, 1985, the participants had an option to contribute to the Plan on a tax deductible (IRA) basis. Prior to that time, all employee contributions were made on an "After Tax" basis. Since June 30, 1985 participants have had the option of contributing to a 401(k) arrangement in the Plan. As the Profit Sharing Plan is the only retirement plan arrangement maintained by Flint Ink Corporation, the employees are keenly aware of its many features and take a role in promoting the Plan among themselves. The passage of legislation adverse to retirement plans will have a serious effect on the employees' morale and their incentive to be efficient and profitable.

Respectfully submitted,

FLINT INK CORPORATION
PROFIT-SHARING & BENEFIT PLAN

John H. Denler, Jr.
Plan Administrator

JHD/jg

Flint Ink
CORPORATION

Established in 1920, Flint Ink Corporation, with its Corporate Headquarters in Detroit, Michigan is the nation's leading manufacturer of newspaper inks and a leading producer of inks for commercial, publication, forms and packaging printing. The corporation operates plants in thirty-five locations across the United States and Mexico and employs more than 1,200 people.

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F

FORDHAM UNIVERSITY Bronx, N.Y. 10458

FEB 11 [illegible] 1:3

Department of History *(212) 579-2278,79*

January 30, 1986

Senator Robert Packwood
Chairman
U.S. Senate Finance Committee
U.S. Senate
Washington, D.C.

Dear Senator Packwood:

I would like to submit the attached as written testimony before the Finance Committee on the revised tax bill. Several provisions of the House bill, unlike Treasury I, will have a disastrous and discriminatory impact of college and university teachers, and should be changed in any new legislation.

- unlike businesses, employees of non-profit institutions are ineligible for 401 k deferred contributions to pensions.

-the one percent exclusion on business expenses hits particularly hard on college professors, whose employers routinely do not reimburse faculty employees for important businness expenses such as stationary, research travel and copying costs, attending conventions when not delivering a paper etc. Most commercial enterprises would cover a lot of this as employer expense and pass it on to the government and the consumer. Non-profit institutions,which cannot,expect their employees to pay some of the costs for performing their expected duties.

-although the bill is supposed to be revenue neutral for the government, it is certainly not revenue neutral to one class of taxpayers, two-income professional married couples in the 50-80,000 range. These people will suffer greatly increased rates, while the poorer and richer taxpayer will be protected. If they come from a high tax state such as New York, the impact is greatly magnified by the new bill.

- the federal government has already singled out college professors for unusual and special treatment. Professors at private institutions are forbidden to form unions under the protection of the NLRB. They are among the few Americans excluded from the right to continue working past 7o. If we cannot bargain for our wages, nor continue working in our old age, please make sure we get a fair tax rate on salary and the chance to save some of it for our old age.

-professors are already greatly underpaid compared to doctors and lawyers. How are we going to keep top people on the job to educate our chilren to the required high standards?

Sincerely,

Roger Wines
Professor of History

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STATEMENT
OFFERED IN TESTIMONY TO THE SENATE FINANCE COMMITTEE ON NEW TAX LEGISLATION

Dr. Roger Wines
History Department
Fordham University
Bronx NY 10458
212 579 2278

January 30, 1986

Negative Effect of Tax Reform on College Teachers

QUALIFICATIONS : Professor of History at Fordham University, 1959-date. Vice President of Faculty Senate, Chairman, Faculty Handbook & Statutes Committee at Fordham, former member American Association of University Professors national Board, as well as N.Y. State Board .

MAJOR PROBLEM AREAS IN HOUSE BILL: The following have an unfairly harsh impact on college professors and should be reconsidered as policy:

- discriminatory treatment in 401 k deferred income for pensions, for employees of non-profit institutions, as opposed to business

- impact of one per cent exclusion on employee business expenses damaging to research activities and professional activities of professors, who have to pay for business costs personally, which business employers usually assume.

- taxation of graduate and professional school tuition remission to dependents of college faculty members (since July 1, 1985).

- this supposedly revenue neutral bill is not tax neutral to one class of taxpayers, two-income professional families with a joint income in the 50,000-80,000 dollar range. Their taxes are disproportionally raised. If they come from a high income tax state with a lot of social problems like New York, the impact is greatly increased if tax deduction for state and local taxes is also dropped.

- the federal government has already singled college professors at private institutions out for special treatment. The Supreme Court ruled that they may not form unions with the protections of the NLRB. Congress provided that unlike most Americans, they do not have the right to continue working beyond age 70.

-if college professors cannot bargain for higher salaries, or work in their old age, let us at least provide them with the chance to pay a fair share of taxes and to establish a decent pension, using deferred pension plans such as TIAA and/or IRA's. You know what doctors and lawyers earn, compared to professors. How will we continue to attract the bright young faculty we need to insure the education of tomorrow's America?

ELUCIDATION OF POINTS OF TESTIMONY

1. Deferred Pension Contributions: I refer you to the testimony to be submitted by the Teachers Insurance and Annuity Association (TIAA). This industry-wide pension system was founded as a philanthropic gesture by Andrew Carnegie, to help provide career security for college teachers, and enable our best minds to devote a lifetime career to the profession. Congress should consider following the same policy in 1986. The Senate, led by Senator Javits, used TIAA and its experience as a model in considering federal pension legislation.

It is ironic that tax deferred pension contributions were originated for the benefit of employees at non-profit educational and other useful institutions, which could not pass pension costs on in the form of tax deductions to the government or fee increases to consumers. Later the 401 k extended this to business. Now it is proposed to keep the deferral of pension income for business, but to cut the non-profit institutions out of eligibility.

Professors generally earn a great deal less over a lifetime career than peers with other comparably demanding careers. A deferred pension is much more important for a professor at a non-profit institution than for a business man, and because of the way in which professors move from one institution to another in the course of a career, it is essential that an industry-wide non-profit pension plan such as TIAA be granted the same tax position as other pension plans will enjoy.

Professors at non-profit institutions do not have the protection which those at large public universities, with strong unions and public pension plans, enjoy.

I urge that Congress allow TIAA to retain the position which it has enjoyed under past and existing tax laws, if necessary as a special exception in the act.

2. Professors and Exclusion of Employee Business Expenses:

Business employees are usually provided by their employer with the necessary small tools and materials for work, as well as full reimbursement for business travel. Professors are not, and have to lay out considerable sums from their own pocket, in the performance of their expected duties.It should be noted that the job descriptions of college professors, and I cite my own statutes at Fordham University as an example, actually require that professors do much more than teach classes: they are expected to subscribe to expensive professional journals, buy professional books, pay dues in professional societies, travel to do research and to go to educational or professional meetings, and in amny cases to pay for some materials and supplies used in their research. Only a small part of this is usually reimbursed or provided by foundation or government grants. Most of it is borne directly by the faculty member as a condition of employment. "Publish or Perish" is no idle saying to a faculty member seeking tenure or advancement in his or her career.

At Fordham, for example, professors who travel to a professional meeting are reimbursed by their employer only if they are giving a paper, recruiting, or are an officer of the organization, or a representative of Fordham University. Most professors who attend one or several meetings each year have to pay all or most of that cost. Last year I had to make trips to Washington D.C. to use the National Archives for Historical Research. As had frequently been the case in past years, I was not reimbursed for train, taxi, hotel, meal and xeroxing expenses. We are not talking about big-time spenders or three martini lunches. I ate in cafeterias and stayed at modest hotels.

As an historian, I have to pay for cost of books, professional journals, stationary used in research, xeroxing and microfilming research documents at libraries and archives, and occasional major expenses such as this typewriter, a camera etc.

Since my non-profit employer has no funds to pay for all this, nor can the employer pass on costs via tax deductions like a business, and since Fordham is competing with very cheap public colleges for students, I have to pay for such expenses, which might total up to 900-1500 dollars a year out of pocket. My only hope of recovering something is by legitimately deducting them as business expenses. If you are not putting a one percent exclusion on General Motors , why should you put it on me?

I do not spend ten or twenty per cent on employee business expenses, the first one per cent counts. If we were talking Treasury I with no deductions for anyone, it would be a different story. But why discourage research and scholarship with a tax proposal focused in just this way?

I urge the Senate to reconsider a one per cent exclusion of business expenses incurred by employees in the performance of their assigned duties, so that they will receive comparable treatment with independent contractors or businesses.

3. Taxation of Tuition Benefits for Professors' Dependents and Professors

In general we have defined education at all levels as a public good and a goal to be furthered by encouragement of private contributions and expenditure of vast sums by federal state and local governments. It runs counter to this policy to place a tax on educational scholarships provided by educational institutions for employees, and their dependents. Up until 1985 these were always tax-free, and since then some have been taxed. The law should not tax:

- a professor seeking to acquire new skills or to retool in a different field

- his spouse, who is returning to a work career after several years of raising children, and who needs additional education

- a professor's children who have met the academic qualifications for admission to a professional or graduate school

and yet the 1985 tax changes have had this effect. Persons who previously received scholarship benefits because of dependent status now have to compete with other candidates for scarce scholarship resources, and incur federally subsidized student loans to pay their parents income taxes.

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This was a tax "reform" that discourages education and costs the government money. People at private, non-profit institutions who would benefit from this provision are a very small group. The government gains in the long run from the higher lifetime salaries paid by professionals with additional education.

Moreover it makes little sense to exempt undergraduate education and education at private academies, and then tax graduate and professional tuition remission.

Among the anomalies produced by the law let me suggest one:

At Fordham, nephews and nieces of Jesuit faculty members, who are not tax-dependents, receive tax exempt scholarships to professional and graduate school. Children of lay faculty members do not.

I urge the Senate to encourage scholarship aid to students from whatever private sector source may wish to contribute such aid. Please remove from the new tax law any provision taxing educational benefits for employees and dependents.

4. Impact of New Tax Bill on Two-Income Professional Families:

Granted that everyone's situation in income and taxation is different, it is not uncommon today to find two income families on college faculties. The social demands of trying to live an upper middle class lifestyle on a lower middle class salary, and the deep desire of educated people to insure a comparable level of education for their own children, as well as the lower salaries generally paid to college faculty at private institutions often compel spouses to work.

The proposed revenue neutral tax law is not taxation neutral for one class of taxpayers. While plus or minuses of a few hundred dollars affect most classes of taxpayers, there would be a very large impact on two-income professional families jointly earning between 50,000-80,000 per year. I urge you to adjust tax rates or deductions to make tax changes in that bracket comparable to those made for the other poorer or richer taxpayer.

5. Additional Impact of Elimination of State/Local Tax Exemption

Although a separate issue, there are many private colleges in states such as New York which have extraordinary social welfare expenses and crime control expenses, many of them resulting from a failure of the federal government to enforce its own laws on drugs, crime and immigration. The local taxpayer, including the college professor has to pay a large share of the social costs, in income and property tax, making living costs much higher than in other areas of the country. Until federal enforcement becomes effective, or the federal government starts assuming rather than shedding social costs, it should not penalize taxpayers of states which have to take care of the problems, by taxing those same state taxes twice.

Respectfully submitted, Roger Wines January 30, 1986

P

SENATE FINANCE COMMITTEE

Testimony for Inclusion in the Minutes of Tuesday, February 4, 1986

Bernice Glatzer Rosenthal

Fordham University

Bronx, N.Y. 10458

This is to testify on the catastrophe that capping TDA contributions to 403b and 415 plans at only $7,000 would entail for female employees of colleges and universities, especially single parents.

The uniform cap of $7,000 makes no distinction between those who have an adequate employer financed retirement system and those who do not. It ignores the need for follow-up measures such as requiring employers to fund adequate pension plans and/or voiding state laws which exclude tenured professors from the protection of bans on mandatory retirement.

403b plans were created to put employees in the non-profit sector into parity with the private sector and are not at all comparable to 401k plans. TIAA was created by Andrew Carnegie in 1918 to attract and retain good people in college teaching. It has been tax exempt since 1920. CREF was created in 1952 and has been tax exempt since 1953. Both plans exist because many non-profit institutions are unable to fund adequate retirement plans for their employees. Even within the non-profit sector there are great differences in the ability and willingness of employers to fund adequate retirement plans. Public colleges and universities offer pension plans, often generous, paid for by the taxpayer. Private colleges and universities vary widely. Dartmouth College, for example, contributes 17% of faculty salary to TIAA-CREF, but Fordham University contributes only 5%. Employees of Fordham and of similar institutions therefore, must finance their own pension plans. Reducing their ability to do so, by restricting TDA contributions, condemns them to an old age of poverty.

Female employees, especially single parents, are particularly hard-hit. Women's career cycles are different than men's. Many, if not most, academic women start their careers late for a variety of reasons. Hence they have fewer years in which to accumulate retirement credits. Moreover, since promotion tends to be slower for women, it takes them longer to reach a salary level at which they can afford to save.

My own case is more dramatic than most, but it is not atypical in its basic pattern--a woman who never expected to work finding herself the sole support of herself and her children.

I was born and grew up in the South Bronx. My parents were very poor. A 'Cinderella' marriage turned into a nightmare and I escaped, quite literally, eight months pregnant, from the foreign country where my then-husband and I were living. Determined not to go on welfare, I lived with my parents in the Bronx, got my degree and my first job. By then I was over 30. My former husband has not paid one cent of child support since our daughter was born (she is now sixteen years old) even though he is a millioniare. (He resides outside U.S. jurisdiction). After sixteen years of struggle and sacrifice, I managed to reach a middle income salary and also to build a national reputation in my field. Now, just as I can begin saving for retirement, tax 'reform' pulls the rug out from under me and condemns me to an old age of poverty by destroying my ability to accumulate retirement funds.

If the Senate Finance Committee could interview academic women now in middle age, they would find many cases where the ability to 'catch-up' on retirement contributions is crucial.

Tax deferred annuities are the ONLY way unmarried people can save for retirement, because taxes on unmarried people are so high. True, the House Tax 'Reform' Bill lowers tax rates, but it also lowers thresholds. The thresholds for unmarried people are set so low that those in the middle-income brackets will not enjoy a net decrease in tax liability. The definitions of 'middle-income' and 'upper-income' for unmarried people are totally unrelated to the actual cost of living.

The childless single enters the 25% bracket at $12,500 which is most definitely not middle income in high cost areas of the nation. She enters the 35% bracket at $30,000 which is not upper income on the East or West coast.

The single head of household is in an even worse position, for she faces the huge expense of raising a child on only one salary (very few receive child support from their ex-husbands) as compared to the married couple's two salaries, or potential of a second income if needed. The single mother does not get a discount on food, housing, clothing or tuition for her children, yet she enters the 25% bracket at an income of only $16,000 as compared with $22,5000 for a married couple with virtually identical expenses. She enters the 35% bracket at an income of only $34,000 as compared to $43,000 for the married couple. Bearing alone the expense of raising and educating children, the single mother will have no discretionary income for saving until her children are grown, but at that point (and by then she may be age 50), she falls into an even higher tax category and again cannot save, unless contributions to a retirement plan are tax deferred.

Recent proposals to limit the $2,000 personal exemption to the first two brackets impact unfairly on unmarried people because of the unrealistically low levels at which they reach the highest bracket. State and city taxes compound the injustice.

Thus, for unmarried women, limiting TDAs has a double whammy. Their retirement plans are destroyed while their taxable income is increased and the additional taxable income brings them into the next bracket, if they are not there already. This, of course, means that they are unable to accumulate any personal savings. Women who do not own their own homes will not have enough retirement income to pay the rent in a safe neighborhood; at the very age at which they are most vulnerable to violent crime, they will have to move to a dangerous slum.

Surely a tax 'reform' which allows the rich to deduct mortgage interest and local property taxes on their second home and finds room to accomodate all sorts of special business interests, can find a way to save the present teacher retirement system rather than condemn women who have worked their way out of poverty to a return to poverty in their old age.

STATEMENT TO
United States Senate
Committee on Finance
By
John H. Bowen, M.D.
President, Forest Farmers Association
February 10, 1986

Mr. Chairman, committee members, my name is John Bowen, a private timberland owner from Maryville, Tennessee, and president of Forest Farmers Association, an organization representing private timberland owners in the southeastern United States.

My testimony is directed toward the Tax Reform Bill (H.R. 3838) and its adverse effects on the private timberland owner in the South.

Private growers hold 70 percent of the southern timberlands. Members of Forest Farmers Association own or manage some 40 million acres, and we support the Congress' effort to overhaul the tax code to make it simple and fair. But for timber growers, this tax proposal is neither fair or simple. It will, in fact, return our nation's timber resource to the pre-1944 years when we saw an alarming decline in timber inventory. Conservation, reforestation and timber management were not being practiced. In 1944 amendments to the tax code provided for timber capital gains treatment. With that economic incentive, owners were encouraged to invest in capital improvements and to increase management of timberlands. During the years preceding 1944 the United States' timber growing stock had been in a steady decline. After 1944 it began a slow but steady recovery. Now new studies indicate that demand has outpaced growth in many areas and our growing stock is dropping. With the House tax bill we face the added threat of legislation that will discourage tree planting and scientific forest management.

Capital Gains. I mention capital gains first since it was the legislation that turned forestry around in 1944. It takes a born optimist to establish and manage a stand of timber knowing that it will take from 25 to 50 years before he will have an opportunity to recover his investment. During that period the grower will be at the mercy of fire, insects, disease, ice, wind and a host of other factors, any of which could wipe out his investment overnight. The House bill would eliminate capital gains treatment for the corporate timberland owner who practices this type of intensive management. Forestry corporations who planted and protected their forest in good faith, expecting fair tax treatment at harvest time would have been better off if they had sold their lands and purchased stocks and bonds and been able to receive capital gains under the new proposal. According to a leading forest economist, the House bill will reduce the value of corporate assets by 25 to 30 percent because the maximum tax rate will go from 28 to 36 percent. Higher taxes will cause a substantial drop in return on investment causing fewer capital improvements and reducing the ability of U. S. forest companies to compete with foreign markets. This will cause the private timberland owner to suffer in the long run as his markets for wood diminish.

Reforestation Incentives. The House bill would eliminate the amortization deduction and investment tax credit for reforestation expenses. These incentives have motivated the small timberland owner, the people who own the majority of timberland in the South, and who are the hardest to encourage to plant and protect their forests. Such incentives have been successful because under them forest farmers receive an immediate credit on their federal income taxes.

Capitalization of Management Costs. Under present law, a timber grower must capitalize the cost of establishing a stand. Included are such activities as site preparation and planting. He is then allowed to deduct annually the costs of maintaining a forest such as timber management, fire and disease control, ad valorem taxes and interest on loans. Under the House bill, all of these costs would be capitalized over a 30 to 40 year period for large timberland owners and over five years for those owning 50,000 acres of less. Those who capitalize annual expenses would have to adjust these costs annually for inflation for each tract and species.

In addition, as the House bill is presently structured, any company or individual owning timberland and having debt would have the interest on that debt considered "construction period" interest attributable to the timber, thus having to be capitalized. It would appear obvious that any individual or company having an appreciable amount of debt would be forced to sell any timberlands owned.

Potential impact of H.R. 3838 is obvious. The business of growing trees and manufacturing products from wood raw material has a tremendous effect on the nation's economy, but if you double the tax on timber this will cut return on investment at least in half, resulting in ill-managed forest land. Timber is too important to the economy and balance of trade to let this happen. In the South alone timber is the top value agricultural crop in seven states. The payrolls from manufacturing in forest industries rank either first or second in half of the southern states.

Our members would like for the current taw law to prevail. To receive capital gains provisions just like any other capital investment, to be able to charge off annual timber management expenses (interest, taxes, maintenance costs, etc.) each year and to be able to amortize reforestation expenses over seven years. The tax laws in the past have helped to preserve our natural resource -- trees.

FURMAN UNIVERSITY
FOUNDED 1826
GREENVILLE, SOUTH CAROLINA
29613

OFFICE OF THE PRESIDENT

February 17, 1986

Senate Finance Committee
Senate Dirksen Office Building
Washington, D. C. 20510

Gentlemen:

We at Furman University are adamantly opposed to any changes in the tax-deferred annuity [403(b)] plans. The proposed changes by HR 3838 threaten the retirement income of our University's employees.

Tax-deferred annuities give many of our middle and lower-income employees a vehicle with which to save for retirement. This opportunity makes them less dependent on government-sponsored retirement programs and, therefore, should assist the government in its effort to reduce expenses. Thank you for your support in this matter.

Sincerely,

John E. Johns
President

JEJ/de

G

Office of the President
515-236-2587

Grinnell College
P.O. Box 805
Grinnell, Iowa 50112-0810

February 14, 1986

The Committee on Finance
U.S. Senate
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Members of the Committee:

As President of Grinnell College, a private coeducational liberal-arts college enrolling 1,240 students from all parts of the U.S. and 25 other countries, I am writing to urge you as strongly as I can to continue the tax exempt status accorded for so many years to the TIAA-CREF companies.

TIAA-CREF is the pension system for a preponderance of persons -- faculty, staff, clerical, and service employees -- at both private and public institutions of higher education. The system, in short, serves an industry, and this industry is at the very core of the republic's impulses toward creativity and productivity. To inject uncertainty and confusion into this system by undermining the long-held principle of tax exemption for the two companies would have serious consequences for all members of the constituency that the system serves. And this in turn would have equally serious consequences for the conduct of the country's educational activities at large.

In the eyes of all the employees across this country who share and have a stake in it, TIAA-CREF represents the kind of prudent planning and building toward future security that is commended by everyone from our President to the general citizenry. But if the guarantees bolstering the pension expectations of these employees are broken by the impact of HR 3838, there will be disruption and fragmentation as colleges and universities begin looking for alternatives that are less burdensome than the problems this legislation will impose. The very fact that TIAA-CREF is a portable system is highly important to the ready movement of faculty and staff among our colleges and universities. The effects of taxing the system will surely damage this feature of higher education that makes for healthy competition among these institutions.

Assuredly, in a time of continuing economic uncertainty, we should not be about the business of creating further uncertainty, particularly in areas where prudence and stability have been in evidence for so long. TIAA-CREF is a keystone in the structure of American educational operations: it means security to the people conducting those operations.

I can assure you that there are no political or preferential biases among these people in asking you, respectfully, to leave the system as it is. TIAA-CREF is a central part of the benefit plan of all kinds of educational institutions, and it serves persons of varying political persuasions. There is general agreement that this is a good system, and a good system for education is indeed a good system for the country. I ask for your responsible action in leaving it as it is.

Respectfully yours,

George Drake

George A. Drake
President

Testimony Submitted
to the
Senate Finance Committee

On Behalf Of The
Group For Fairness and Stability
in Retirement Planning

This testimony is presented in opposition
to Title XI of The Tax Reform Act of 1985, H.R. 3838

Submitted by:
Joseph W. Blackburn
Sirote, Permutt, Friend, Friedman, Held & Apolinsky, P.C.
2222 Arlington Avenue South
Birmingham, AL 35205

February 20, 1986

SECTION 403(b) ANNUITIES AND UNFUNDED DEFERRED COMPENSATION ARRANGEMENTS

I.

SECTION 403(b) ANNUITIES - H.R. 3838 § 1102

Under current law, an employee of certain tax-exempt organizations can defer up to the lesser of $30,000 or 25% of compensation annually in a 403(b) tax-sheltered annuity. Also, contributions to the 403(b) annuity contract are limited to an exclusion allowance equal to 20% of the employee's "includible compensation" multiplied by the number of years of service with the employer, reduced by amounts previously contributed to the annuity.

Under Section 1102 of H.R. 3838, an employee's elective contributions to a 403(b) tax-sheltered annuity sponsored by a tax-exempt organization would be limited to $7,000 per year. Any amounts deferred under a 403(b) salary reduction would offset, dollar for dollar, the amount that the employee can defer under an IRA. The $7,000 per year limitation also applies to elective deferrals under Section 401(k) plans, limiting an employee's aggregate elective contributions to both 401(k) and 403(b) plans to $7,000 per year.

The revenue generated by this provision will be negligible when compared to its cost to tax-exempt employers and their employees. The recent proliferation of tax reform bills has resulted in unreasonably high legal, accounting and financial costs for employers that must continuously amend, revise and restructure their retirement and deferred compensation plans. The constant change and uncertainty in this area has created a growing skepticism among employees attempting to plan their retirement. If private retirement plans and deferred compensation plans are to be promoted, Congress must stop its continued tampering with the current systems, particularly when the revenue produced by the proposed change of Section 1102 will be insignificant.

The impact of Section 1102 on employees of tax-exempt organizations is potentially devastating. Relying on their ability to fund their retirement under current law, many employees have already foregone current deferrals with the intention of "catching up" in later years as their salaries increase and as they near retirement. Section 1102 now limits their ability to adequately prepare for retirement by imposing a $7,000 annual cap on elective contributions. Congress should not seek minimal revenues when the cost will be a drastic reduction in the standard of living of retired employees of tax-exempt organizations. At a bare minimum, Congress should include provisions in H.R.

3838 that would grandfather existing 403 (b) plans, protect employees and create stability in their retirement planning.

The Ways and Means Committee Report states that the changes made by Section 1102 of H.R. 3838 attempt to remedy an inequity between employees of different tax-exempt employers. According to the Committee, the current limitations "are inequitable because individuals whose employers make contributions to a tax-sheltered annuity on their behalf under a salary reduction agreement may elect to save up to $30,000 a year. On the other hand, an individual who is employed by a tax-exempt organization that does not offer a salary reduction arrangement is limited to a $2,000 IRA contribution."

The Committee's rationale simply proves too much, and in doing so, adversely affects the legitimate deferral opportunities of thousands of employees. Employers' decisions about the type and design of their retirement plans will inevitably result in a disparity in the benefits provided to their employees. This is true whether the employers are tax-exempt organizations using 403(b) plans or taxable entities using Section 401 qualified pension or profit sharing plans. An employer may elect to provide a pension plan allowing employee contributions, or the employer may elect to forego this benefit. Employees can determine for themselves whether this benefit, or lack thereof, creates a total compensation package acceptable to them. To distinguish and penalize employees of tax-exempt organizations by reducing the amount they may defer if their employer allows deferrals is without a reasonable explanation.

The Section 415 limitations and the additional 403(b) limitations (the exclusion allowance) insure that employees under a 403(b) plan will not be allowed deferrals in excess of pension and profit sharing plan deferrals. Employees cannot use 403(b) plans to subvert the normal Section 415 limitations. On the contrary, the limitations imposed by Section 1102 of H.R. 3838 create an unreasonable restriction on the ability of employees to defer income on the rationale that their ability to defer is inequitable vis-a-vis employees of other tax-exempt employers. This additional restriction in no way improves the plight of the employee with no deferral opportunity. Instead, it discourages employment with the tax-exempt employers providing such plans. Given the suppressed salary levels of most tax-exempt organizations, additional limitations can only further reduce the number of qualified candidates interested in positions with tax-exempt organizations devoted to the public good. Thus, the adverse effect of this limitation will be felt primarily by the charitable organizations themselves which must either find additional compensation or lose additional employees to the private sector. Ultimately, the various causes and individuals benefited by these organizations will suffer through decrease in quality services. The provision also unjustly limits those employees who have already given up higher compensation in the private sector to serve these public organizations.

Instead of discouraging employment with tax-exempt organizations, Congress should seek to attract new employees into this area by endorsing employee deferrals and by encouraging employers that currently do not allow 403(b) elective contributions to implement them. In that way, the tax laws regarding pensions would accomplish one of the primary policy goals of federal pension law: to create an incentive for employees to plan for their retirement. The present proposal does just the opposite; it limits the employee's ability to fund his or her retirement and will create added problems for tax-exempt employers already hard pressed to maintain a qualified work force.

It is interesting to note that in discussing the proposed extension of the nondiscriminatory coverage rules to 403(b) plans, the House Committee says that the IRS should consider the "special circumstances" of educational organizations and tax-exempt organizations (i.e., the "compressed salary scales of those organizations and the special needs of certain educational institutions in attracting visiting professors"). While the House Committee on one hand acknowledges the difficulties tax-exempt organizations experience in competing for competent employees, it compounds the problem by limiting tax-exempt employers' ability to design a compensation package attractive to potential employees. There is no real justification for this new obstacle. The perceived "inequity" among tax-exempt employers is nothing more than a reflection of the choice some tax-exempt employers have made to compete more effectively with the private sector for the most qualified employees available. These employers should not be denied this weapon. Their employees should not be denied this opportunity, which may be the only vehicle available to these employees to prepare for retirement. Therefore, the Senate Finance Committee should defeat Section 1102 of H.R. 3838.

II.

UNFUNDED DEFERRED COMPENSATION - H.R. 3838 § 1104

Section 1104 of H.R. 3838 would subject unfunded deferred compensation arrangements of nongovernmental tax-exempt organizations to the current restrictions on such arrangements maintained by state and local governments under IRC § 457. Under IRC § 457 a participant in a deferred compensation plan

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maintained by an eligible employer is not taxed in the year compensation is earned if the compensation is deferred under a plan meeting certain requirements. On the other hand, the participant is taxed on amounts deferred under nonqualifying plans when those amounts are not subject to a substantial risk of forfeiture. One of the requirements of § 457 is that the deferred compensation plan must limit the maximum amount that can be deferred by a participant in any tax year to the lesser of $7,500 or 33 1/3% of the participant's includible compensation (with an increased limit for the three years immediately prior to normal retirement age). Any elective deferral by an employee under a 403(b) plan is treated as a § 457 deferral for purposes of the $7,500 limitation. Amounts deferred under § 457 are treated as contributed to a 403(b) plan for purposes of the 20% exclusion allowance.

The House Committee feels that the amounts deferred by employees of a nongovernmental tax-exempt employer should be subject to the same limitations as deferrals by state and local government employees. The Committee felt that this restriction is proper since the "usual tension between an employee's desire to defer tax on compensation and the employer's desire to obtain the current deduction for compensation paid is not present" in either situation. The fact that the employer does not receive a tax benefit for paying out current compensation has no bearing upon whether the employee can properly defer the actual or constructive receipt of income prior to performing the services that earn the income. Judicial and administrative concepts of constructive receipt and economic benefit should dictate income inclusion, not a vague notion that the conflicting tax goals of an employer and an employee somehow result in a "correct" amount of deferral.

The tremendous use of unfunded deferred compensation plans in the private sector disproves the House theory that employees of tax-exempt employers are not confronted with the "tension" that confronts employees of taxable entities. This alleged tension in taxable entities is substantially overstated, particularly given the fact that most private employers enter into these agreements with the very individuals who own and/or operate the employers and may control the corporation's decision to agree to the deferral. Also, the numerous other tax benefits available to tax-exempt employers make it much less likely that they will oppose an employee's desire to defer compensation. Therefore, there is no real distinction between taxable and tax-exempt employers, and the imposition of $7500 limitation is unjustified.

Because salary levels are generally lower for tax-exempt employers than for taxable employers, the amount of compensation that "highly compensated" employees of tax-exempt employers would be allowed to defer (but for section 457) would probably be no greater than the amount deferred by highly compensated employees of taxable employers. Although the amount deferred by the employee of a taxable employer may be limited by the employer's desire to receive a current deduction, the relatively low pay scale of tax-exempt employers is an equally compelling, and often insurmountable, obstacle to significant deferral by their employees. Yet, taxable employers and their employees are not subjected to any limitation such as the $7,500 limitation of § 457, even though the amount of deferral is, in all likelihood, no less for these employees than for highly paid employees of tax-exempt employers, albeit for different reasons. The House bill seems to be ridding the tax system of an abuse that simply does not exist. On the other hand, for the few employees able to defer more than $7500, the bill is certainly a penalty for their decision to devote their talents to a public organization.

The House Committee would remedy this perceived disparity by bringing the deferred compensation plans of tax-exempt employers into line with the section 457 limitation on state and local government employers. Again, the House further defeats the ability of tax-exempt employers to attract qualified key employees also in great demand in the private sector. While putting nongovernmental tax-exempt employers on a par with state and local government employers creates uniform treatment between these two groups, it ignores the reality that the major competition that tax-exempt employers encounter in recruiting new employees is from the private sector and not from state and local governments. Under prior law (without regard to the questionable impact of proposed regulations), tax-exempt employers at least had the same flexibility to structure compensation packages as did private employers, although the tax-exempt employer may not have the level of compensation available to the private employer. Now, the tax-exempt employer is at an even greater disadvantage relative to private industry. Such a situation should not be tolerated when public policy otherwise supports and encourages scientific, educational and charitable organizations.

The House Committee Report fails to recognize that in 1978, Congress had an opportunity to bring nongovernmental tax-exempt organizations within the purview of Section 457. However, Congress declined to restrict these tax-exempt organizations for many of the same reasons that this new proposal should be defeated. By its failure to restrict unfunded deferred compensation plans for nongovernmental tax-exempt employers, Congress sent a signal to their employees that such plans were an appropriate and preferred method of retirement planning. Many employees have taken advantage of this mechanism and have planned their deferral activities in accordance. Now, only eight years later, the House seeks to defeat the legitimate retirement planning goals of many employees in the public sector.

The detrimental impact on tax-exempt organizations of this proposed change far exceeds the minimal amount of revenue that would be raised. Inevitably, the quality and amount of services rendered by nongovernmental tax-exempt employers will decline as eligible employees opt for employment in private industry. The Senate should not support this result by restricting the ability of employees to defer income in excess of $7,500.

III.

RECOMMENDATIONS

1. The dollar limitations on 403(b) plans should be rejected. Likewise, the rationale for including unfunded deferred compensation plans of tax-exempt employers under the

limitations of Section 457 is seriously flawed and Section 1104 should be defeated.

2. If Section 1102 and Section 1104 are adopted, they should be modified by increasing their dollar limitations to allow employees of tax-exempt employers the same deferred opportunities available to employees of taxable organizations.

3. If Section 1102 and Section 1104 are adopted in some form, the Senate Finance Committee should adopt appropriate grandfathering provisions that will protect participants in existing plans and give effect to their present retirement planning in reliance on current law.

TAB/dra5

HFMA

HEALTHCARE
FINANCIAL
MANAGEMENT
ASSOCIATION

[illegible] STREET, N.W.
SUITE [illegible]
WASHINGTON, DC [illegible]
TELEPHONE [illegible]

STATEMENT OF THE
HEALTHCARE FINANCIAL MANAGEMENT ASSOCIATION
TO THE
SENATE FINANCE COMMITTEE/SUBCOMMITTEE ON HEALTH
ON
CAPITAL FORMATION

FEBRUARY 17, 1986

The Healthcare Financial Management Association (HFMA) has written several letters to the committee individually and in concert with other concerned groups about provisions of H.R. 3838 which affect access to tax-exempt financing for 501(c)(3) organizations. HFMA believes that previous hearings have not devoted appropriate attention to the capital formation issues related to restricting the use of such financing. We are pleased to place our views in the formal record of this hearing.

About HFMA

HFMA is a professional membership association of more than 25,000 individual members who share an interest in the financial management of healthcare providers. HFMA has long been involved in issues surrounding capital payment and formation in healthcare providers. In April 1984, HFMA's Capital Study Steering Committee issued its recommendation for a capital payment methodology for Medicare capital payments. HFMA has a database of hospital financial information used in analyzing hospital financial positions, including capital use and deployment. Annually, reports are generated to subscribers comparing provider-specific performance with the database as a whole. HFMA has also been very active in issues surrounding tax-exempt financing -- a prime/vital source of debt capital in the healthcare industry.

HFMA's Concerns

HFMA is concerned because changes fostered by Medicare's prospective price setting (PPS) system require more capital than will be available under the law's restrictive provisions, the changes could foster an undesirable change in the structure of the industry, access to capital will be restricted to an excessive degree, the public purpose of hospitals is not properly recognized, the proposal inappropriately links national needs to individual state populations, and prudent management or cost saving initiatives will be thwarted.

- PPS Changes Industry

  With the passage of P.L. 98-21, Medicare's prospective price setting system was created. PPS provides new and different incentives for healthcare providers creating an environment of change and turbulence. Restructuring the healthcare system to achieve the desired change requires the formation and effective use of capital. We are concerned that changes in capital financing through changes to the tax laws will create additional unwarranted stress in hospital capital markets.

o Change in Industry Structure

Repeal or severe restriction of tax-exempt financing for Section 501(c)(3) organizations could fundamentally change the structure of our nation's healthcare industry. Access to capital for the various sectors of the industry must be reasonably balanced. If access is significantly enhanced for taxable entities, the very existence of tax-exempt providers is in jeopardy. These unprecedented reductions in federal support for nonprofit healthcare providers would have serious adverse consequences on the patients served by these organizations.

- Access to Capital

The President's proposal would eliminate Section 501(c)(3) bonds, the predominate source of capital for nonprofit healthcare organizations. This proposal would deny many nonprofit institutions access to affordable capital and substantially increase debt service costs for those institutions able to issue taxable debt.

The House bill would place Section 501(c)(3) bonds under a state volume cap and protect only about one-half of their 1984 volume with a $25 per capita reservation. In 32 states, the volume of bonds issued for Section 501(c)(3) organizations in either 1983 or 1984 exceeds the amount available under the reservation. Thus, access will be reduced to an excessive degree.

- Public Purpose

These restrictive provisions fail to recognize that nonprofit healthcare institutions serve public purposes and perform functions the government would otherwise have to provide. The proposed legislation treats nonprofit institutions differently from public institutions performing the same functions. Nonprofit hospitals provide nearly 70 percent of all tertiary, high technology and low volume services that include obstetrics, burn care, pediatric intensive care and cardiac intensive care. Attempting to define public purpose in terms of indigent care provided is not appropriate since indigent care is only one among many public purposes performed by tax-exempt hospitals.

o No Relationship of Need with Population

Approximately 1300 providers have medical education programs. These programs produce physicians and other medical personnel for all hospitals nationwide. Placing such national resources that serve citizens of all states under single state's capital volume caps inappropriately links national needs to the population of the state in which the organization is located. There is little correlation between an institution's need for capital or the number of patients served by the institution and the population or the state in which the institution is located.

- Artificial Restrictions on Cost Saving Options

  These proposals also would deny Section 501(c)(3) organizations advance refunding authority used to reduce interest costs and remove inappropriate restrictive covenants, and would eliminate the use of arbitrage to reduce issuance size and pay issuance costs. The House bill also places numerous other restrictions on bond issuance for Section 501(c)(3) organizations. In addition, the House bill would substantially increase the interest cost on the tax-exempt bonds that could be issued for Section 501(c)(3) organizations by totally or partially denying financial institutions and insurance companies a deduction for interest expense related to holding tax-exempt bonds and by excluding the interest on nongovernmental bonds as a preference item under the minimum tax. These actions thwart sound management steps which might otherwise enhance operations or cut costs.

When examined individually, each provision affecting tax-exempt financing may not appear to be unduly restrictive. However, considered as a whole, they would prove disastrous to access to and formation of capital by healthcare providers. These restrictions will have consequences disproportionate with federal treasury benefits achieved. We strongly suggest that the potentially undesirable outcomes be considered in concert with any possible changes to the tax laws affecting tax-exempt financing. Once considered, we believe the only conclusion is the retention at current levels of access to tax-exempt financing by 501(c)(3) nonprofit hospitals.

HFMA is pleased to provide these comments. If you have any questions about our testimony, please feel free to call Ted Giovanis or Ronald Kovener.

H. L. LYONS COMPANY
811-813 WEST MAIN STREET LOUISVILLE, KENTUCKY 40202 U.S.A. PHONE: 502-587-6470

February 19, 1986

Attn: Betty Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Building
Washington, D.C. 20510

Dear Ms. Scott-Boom:

Please note that I should like to go on record as feeling that there are more pressing concerns for the Senate to consider at this time than tax reform (e.g. HR 3838) which I believe has many flaws.

My suggestion is that more time be devoted to the problem of spending and deficits.

Sincerely,

H.L. Lyons

H. L. Lyons, President

cc: the Honorable Senator Wendell H. Ford
the Honorable Senator Mitch McConnell
NAM - Southern Division

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1985

February 7, 1986

The Honorable Robert Packwood
Chairman-Senate Committee on Finance
219 Russell
Senate Office Building
Washington, D.C. 20510

Attention: Betty Scott-Boom

Dear Sir:

In my opinion, as a businessman who has to compete in today's market, I feel that the House passed version of tax reform, as it stands today, is anti-growth and anti-jobs. I urge the Senate to set aside tax reform for now, and turn its attention to the nation's twin deficits - spending and trade. Improvements in these areas would do much to negate an anti-business tax reform bill.

I hereby request that these comments be included in the hearing record.

Sincerely,

Robert Meadows
Treasurer & General Manager

R. Meadows

cc: National Association of Manufacturers
Southern Division

RM/pb

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STATEMENT OF JOHN B. HUFFAKER, COUNSEL FOR CERTAIN RELIGIOUS COMMUNITIES INCLUDING HUTTERIAN COMMUNITIES AND COMMUNITIES OF THE ORDER OF THE CISTERCIANS OF THE STRICT OBSERVANCE

I am the special counsel for a number of religious communities that are described in Section 501(d) of the Internal Revenue Code. These religious communities maintain a common treasury for their members. A condition of exemption from income tax of the organization is that the members agree to report their pro rata share of the income on their own returns. Some of the communities are formed by persons generally known as Hutterites. These include both farming and non-farming communities. In addition some religious communities that are monasteries of the Order of the Cistercians of the Strict Observance are also organized to come within the scope of Section 501(d).

Once it is recognized that Section 501(d) organizations are merely pass through organizations and that their income is subject to income tax at the member level, then the oversight in not permitting the pass through of the investment credit is obvious. This matter was the subject of hearings before the Subcommittee on Select Revenue Measures of the Committee on Ways and Means in October, 1984. At that time, the Subcommittee had before it H.R. 4507 Since the hearings were so late in the session, no further action was taken in 1984 but a similar bill has been introduced in the current Congress as H.R. 1723.

The Ninth Circuit has stated that "exclusion of §501(d) organization from the tax credit offered by §38(a) does not seem to advance any articulated legislative purpose." (Kleinsasser v. U.S. 707

F.2d 1024, 1029) I appeared at the hearing accompanied by representatives of the Hutterian Brethen of the State of Washington, The Order of the Cistercians of the Strict Observance and the Hutterian Society of Brothers. The explanation of the situation of the organizations presented to the Ways and Means Subcommittee remains appropriate. The following is a complete transcript of the testimony at the hearings and it is requested that this testimony be incorporated into the current hearings:

AFTERNOON SESSION

Chairman STARK. The committee will resume.

We will call Father Paschal Phillips, Brother Wollman, Brother or Mr. Stevenson, John Huffaker and Leonard Jensen, counsel for the organizations represented by the witnesses to testify on the bill H.R. 4507. And I wanted to bring the regards of Congressman Foley to his friends from the State of Washington.

He has been quite busy on the floor of the House debating a rather contentious amendment and was unable to be here and he asked me to send his regards.

He is the author of this bill and I was proud to cosponsor it, as a matter of fact, at the request of former Governor Jerry Brown of the State of California.

You may proceed in whatever manner. I think we have prepared statements—not only prepared statements, we have prepared sweets and goodies for which I thank you.

If you would like to summarize your statement as best you can, you may start in any order that you are comfortable.

STATEMENT OF JOHN B. HUFFAKER, COUNSEL, ORDER OF THE CISTERCIANS OF THE STRICT OBSERVANCE, COMMUNITIES OF HUTTERIAN BRETHREN IN WASHINGTON STATE, AND COMMUNITIES OF THE SOCIETY OF BROTHERS

Mr. HUFFAKER. Thank you, Mr. Chairman.

We appreciate being here. I am John Huffaker, acting as counsel. With me is cocounsel, Leonard Jensen.

This bill is sponsored by three groups of religious communities. We have the Hutterian Brethren of the State of Washington who are represented by Jake Wollman; the Order of the Cistercians of the Strict Observance, better known as Trappist, represented by Father Phillips.

Father Phillips is from Oregon. Mr. Wollman is from Washington. Then the Society of Brothers represented by Alan Stevenson, of Connecticut.

We are very pleased that we have as a sponsor or cosponsor each of the States in which we have a community, and as you know, Mr. Chairman, one of the largest of the Trappist monasteries is in the State of California.

We felt the Treasury did a very fair job of summarizing the purpose of the bill. These religious communities do not pay tax on their business income, but the business income is all taxed to the members of the community.

In that way it is very much like a partnership or a subchapter S corporation. For years many people thought that because they were required to file partnership tax returns, the provision for partnerships passing the investment credit through to the partners applied to them also.

However, the ninth circuit in the *Kleinsasser* decision, a little over 1 year ago, held that "Reluctantly we affirm. While we see no legislative purpose being served, nevertheless only Congress can provide for the pass through."

So, therefore, we have designed a bill working closely with the staff that is constructed to permit the pass through. It is so constructed to produce minimum administrative problems, and we do have one staff amendment that—or one amendment to offer that we have discussed with the staff that would restrict the bill to those religious communities in which all persons enjoy substantially the same standard of living.

Now, Mr. Chairman, I want each of the community representatives to explain briefly to you what his community does and as you listen think of the Treasury's objection, the Treasury had two objections.

In the first place, they said this might lead to grant of other credits. I want to assure this committee that we do not see any other credits that are either important or really relevant.

Second, they said it would give a competitive advantage. We think we presently suffer from a disadvantage because all other taxpayers who make these investments get the investment credit.

I would like Mr. Wollman, in not more than 4 minutes, to summarize the situation in the Warden community of the Hutterian Brethren.

[The prepared statement follows:]

STATEMENT OF JOHN B. HUFFAKER, COUNSEL, COMMUNITIES OF HUTTERIAN BRETHREN IN WASHINGTON STATE, ORDER OF THE CISTERCIANS OF THE STRICT OBSERVANCE, AND THE COMMUNITIES OF THE SOCIETY OF BROTHERS

This statement is submitted by John B. Huffaker and Scott B. Lukins as counsel for the following groups: Communities of Hutterian Brethren in Washington State, the Communities of The Order of the Cistercians of the Strict Observance that are described in Section 501(d), and the Communities of the Society of Brothers. Members of each of these groups will appear with the panel at the hearing in order to explain how their communities are conducted and to answer any other questions.

Religious communities that elect pursuant to Section 501(d) are not taxed on the income, but the members must report each one's pro rata share of the income as a dividend. Each community is required to maintain a community treasury and as a practical matter the members living in the community actually handle very little cash. Although it is not a requirement of the statute, the members of the communities for whom this statement is submitted are all subject to a vow of poverty. All the corporations are membership corporations, so that the member does not own a fractional interest of the community property.

The predecessor of Section 501(d) was enacted about 50 years ago to provide for a special rule for the taxation of those religious communities that were not entitled to income tax exemption under the existing law, because the community conducts a business that supports the community and, if possible, produces an excess that can be used to further the charitable and religious purposes of the community. Section 501(d) is remarkable for the long time that it has been in the Code and the lack of litigation that has surrounded its application. We are informed by the Internal Revenue Service that there are currently about 75 organizations in the United States that have elected under Section 501(d). In many ways Section 501(d) was a very simple form of Subchapter S for membership corporations. It was passed before the investment credit, and it was entirely proper to merely provide for the pass through of the income. Interestingly there is no provision for pass through of losses or numerous other provisions that complicate the rules for Subchapter S for participants.

When the investment credit was introduced provision was made for the pass through of the credit from a partnership to a partner, from a trust to the beneficiary and from an S corporation to the shareholders. We believe that the failure to cover the members of an electing religious community was an oversight easily understandable in view of the small number of communities involved and their relatively small size.

The regulations have for many years required the organization to file a partnership return. Since this return provides for the pass through of investment credit, many communities assumed that this also applied to them. However, the Internal Revenue Service and the Ninth Circuit disagreed. The opinion in *Kleinsasser*, 707 F.2d 1024 (9th Cir., 1983), states:

"Reluctantly, we affirm. . . .

"Our conclusion from this brief statutory exegesis is that the exclusion of § 501(d) organizations from the tax credit offered by § 38(a) does not seem to advance any articulated legislative purpose. But it is equally clear that there is nothing in the legislative record to suggest that Congress meant to exempt § 501(d) organizations from the sweep of § 48(a)(4). The lack of clear contrary legislative intent gives us no choice but to enforce the plain language of the statute.

"We cannot put an equitable gloss on the clear language of the Internal Revenue Code. The statutory inequity involved in this case, if there is one, may only be remedied by Congress. We realize that, in light of the Hutterites' religiously based abstention from secular politics, it may ring hollow to advise the members of Milford Colony to go to Congress for relief. But it is from that body alone that relief is available." . . .

This legislative effort is a response to the suggestion by the Court that Congressional relief is appropriate.

The economic activity of each of the three groups is one that would require investments that would qualify for the investment credit if made by any other organization, the income of which is taxed either to the organization or by reason of pass through provisions to others.

The Hutterian Brethren of Washington live in four communities. Their economic activity is farming. Both the raising of potatoes and wheat require large investments in farm machinery.

Three communities of the Order of the Cistercians of the Strict Observance have made the election under § 501(d). The Cistercians are better known as Trappists. Each of the three communities conducts an economic activity that is designed to support the community. The community at Red Bluff, California raises nuts and dates. The community at Lafayette, Oregon farms and binds books as well as making fruitcakes. The community at Trappist, Kentucky, makes cheese and fruitcakes, as well as farming.

The three communities of the Hutterian Society of Brethren engage in an integrated economic activity. For over 25 years they have manufactured and sold playthings for use in kindergartens, nursery schools, and the like. More recently they have begun manufacturing special tables, chairs, and other special devices for use by the handicapped. One community is in New York, near Kingston, one in Connecticut, near Norfolk and one in Pennsylvania, near Scottsdale.

These communities share several important characteristics. (1) The members of each are united by a common religious philosophy and desire to witness their faith by living in community. Each of the communities is relatively secluded, and the community lives apart. (2) The comment to the community is generally a life-long commitment. The membership is very stable. (3) The members live a very simple life that is shared by all the members. (4) Each community seeks not only to support itself, but makes an effort to create an excess that can be used for charitable and religious purposes. The community does not want to be dependent on the charity of others. The work is carried on in the community using the services of the community members as much as possible.

H.R. 4507 was drafted with the assistance of the staff of this subcommittee. We are pleased that the chairman, and Mrs. Kennelly and Mr. Schulze are co-sponsors to the bill introduced by Mr. Foley. In addition, Mr. Rangel and Mr. Boland are cosponsors. Communities that are supporting this legislation are located in the states of each of the sponsors and the cosponsors.

In our discussions with tax specialists we have found that not many have any experience with § 501(d). At a meeting of the American Bar Association Tax Section Committee on Tax Exempt Organizations this proposal was discussed and we found a necessity to introduce even these specialists to this problem, but at the conclusion,

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an overwhelming endorsement of the bill was given by the committee. We perceive no legislative policy for not allowing the credit to be claimed by the members since they are being taxed on the income.

TECHNICAL DESCRIPTION

The bill proposes to add new Subsection 48(r). Section 48 contains the special rules for investment credit property. Generally it provides for the pass through of the credit for organizations the income of which is taxed to another person but provides that no credit is permissible when the income is not taxable. Thus, for tax-exempt organizations the credit is only allowable for investments related to unrelated business income.

Proposed Subparagraph (r)(1)(A) will define a community business of an "eligible § 501(d) organization" as an unrelated business for purposes of § 48(A)(4). The provision will not apply to any non-business investments.

Subparagraph (r)(1)(B) provides that the qualified investment is apportioned pro rata among the members in the same manner as the income. Thus, if a member is allocated one percent of the income for his share, he would be allocated one percent of the investment.

Subparagraph (r)(1)(C) tracks provisions related to pass through for other types of organizations so that qualified investment by the organization is treated as new property by the member if it was new property at the outset.

Paragraph (r)(2) applies the used property limitation at the organization level. This makes it unnecessary to provide a separate limitation at the individual level when no credit would be allowed to a member in Paragraph (4) if he claims credit for investments other than investments by the § 501(d). This simplification of the statute is possible since a member of the religious community is by his membership in the community excluded from investment in property other than through the community. In the relatively rare instance when a member changes communities during the year, the member would be required to choose, since he would not be able to claim for both communities.

Subparagraph 3 provides for recapture to be determined at the organization level. The burden is to be borne in the same way the income for the year of recapture is allocated. This avoids any problems of tracing.

The scope of the Section is limited by Paragraph (5) to the organizations that have demonstrated a stability, so that the Service would not be facing the problem of a short-lived community that had claimed the credit and then had disappeared. The suggested test is that the religious community must have been in existence for more than five years, or more than one-half of its members have been a member of a religious community for more than five years.

Our attention has been directed to the apparent anomaly of a pro rata allocation of credit and income when a religious community maintains one or more persons at a sustantially higher standard of living than most members. Therefore, we propose a new Subparagraph 5(c) be added to exclude the term "501(d) eligible organization." Any organization that provides a substantially higher standard of living for any person or persons than it does for the majority of the community could not avail itself of the pass through. The person supported in the manner substantially higher than the members as a whole could be a person other than a member.

The effective date of the bill will make it applicable to periods beginning after december 31, 1978. This is based upon our belief that the omission of a specific provision in the statute is merely an oversight and most of the corrections in the 1982 Technical Corrections Act and other similar bills have had the same effective date as a legislation that was being corrected. However, the oversight in this instance is of such duration that this seems improper. Therefore, we have suggested an effective date that would be applicable to those years that would normally be open at the time of the decision in *Kleinsasser*.

We appreciate this opportunity to present our sttement. We look forward to working with the staff to perfect this legislation and to its early reporting, passage and enactment.

Chairman STARK. Proceed.

STATEMENT OF JACOB WOLLMAN, PRESIDENT, WARDEN, WA, HUTTERIAN BRETHREN, COMMUNITIES OF HUTTERIAN BRETHREN IN WASHINGTON STATE

Brother **WOLLMAN**. My name is Jacob Wollman, president of Warden Hutterian Brethren. We are a community which lives in the State of Washington which is about 100 miles south of Spokane.

We are a farming community and we derive all of our income from agriculture. We are not a community which is based on material things.

We are a community which provides for our members because we believe that is the way the Lord has put the way before us.

We believe the command of love and we have to do what we are doing. That is why we are having communal cooperation and that is why in this case everybody works at the communal task and we have all of our income put together.

Being that we are farmers in the State of Washington, we do a lot of extensive farming. I have with me here a display of 10 different crops which we in our own community raise right now.

To raise crops like that takes a lot of equipment. There are different crops of many varieties.

We have over the years been recognized in the State of Washington to be very efficient farmers and stewards of the land. We can only do that if we are able to purchase equipment and facilities and keep these crops in good order whereby we can have investment tax credits like other people.

We pay taxes on this—pay taxes like other Americans do. We pay taxes on our income. Naturally right now the farming industry is at a very, very low ebb.

I don't have to tell you that agriculture is in a very, very tough situation. Our farm prices are low. We need these tax credits for survival.

We need to be able to spend our moneys, put our moneys back into our land and equipment and facilities whereby we can provide for our people.

We take care of our own people. We believe that we should be no burden to the Government whatsoever.

We educate our children with State accredited teachers. We teach honesty, respect for law and order, and all that I am asking is that we get a fair break.

We want to have and be able to spend our money like all other organizations can spend and get the benefits whereby we are then an asset to our area when we can buy equipment and have the latest in equipment and get the advantage which we absolutely need.

Thank you for letting me testify.

Chairman **STARK**. Thank you very much. Do you want to proceed with whom?

Mr. **HUFFAKER**. I would like Father Paschal Phillips to relate the situation in the Trappist monasteries.

STATEMENT OF FATHER PASCHAL PHILLIPS, OUR LADY OF GUADALUPE MONASTERY, ORDER OF THE CISTERCIANS OF THE STRICT OBSERVANCE, LAFAYETTE, OR

Father **Phillips**. I am Paschal Phillips, business manager of the Trappist Monastery in Oregon. Our rules were written about the year 530.

The Trappists came to the United States in 1849 and we have been established in my community for 40 years. The point being that we are stable communities which need to invest in a regular manner to stay alive.

We are a Roman Catholic organization. You are probably aware that most Roman Catholic organizations are listed under 501(c)(3). We found that it didn't fit us which emphasizes the fact that it is not a denominational question, it is a question of the internal organization of the community.

We found the section 501(d) fits what we really are. We really divide all the income. That is the reality of it.

So it fits. But we cannot understand why we can't get the investment tax credit because the purpose of the investment credit was to stimulate the purchase of productive equipment.

The purpose is equally well satisfied whether it is a Trappist community or some other group that buys.

There doesn't seem to be any—like the ninth circuit, there seemed to be no reason whatever. All the monks work, the income is very limited, partly because we only work 4 hours a day, and what surplus we have is distributed to the poor.

So the community lives a very modest life. Nevertheless, we do produce in my community a fruitcake. I also gave you all a booklet where the centerfold shows the monks working. We have a forest industry and we are bookbinders. We are all commercial and we don't object to paying taxes, never have. That is fine. All we ask that we be taxed in the same basis as our neighbor down the street.

Thank you for this opportunity.

Chairman **Stark**. Thank you, Father Phillips.

Mr. **Huffaker**. The remaining group which is the Society of Brothers, have communities in Connecticut which explains Mrs. Kennelly's sponsorship, one in Pennsylvania, which exlpains Mr. Schulze's cosponsorship, and one in New York.

Alan Stevenson will explain to you how these communities conduct themselves.

STATEMENT OF ALAN J. STEVENSON, DEER RUN HUTTERIAN SOCIETY OF BROTHERS, COMMUNITIES OF THE SOCIETY OF BROTHERS, NORWALK, CT

Brother **Stevenson**. My name is Alan Stevenson, and I represent the three Hutterian Societies of Brothers Communities in New York, Pennsylvania, and Connecticut. We do belong to the Hutterian Church of which Jake Wollman has told us, but we evolved differently.

We evolved in Germany, and with a total commitment to a Christian life and were expelled under Hitler and after some wanderings we settled in America where we were very gratified to have religious freedom.

We have been here for 30 years and in that time we have built up a business of supplying kindergarten equipment and school equipment to schools and kindergartens and day care centers and church schools all over the country.

In recent years we have also manufactured equipment for handicapped people. I think there is a catalogue of just our handicapped items.

This enterprise has supported us over the years and we do buy machinery, of course, for our workshops, which are woodwork and metal shops. Since we buy the machinery, it would help us to have the pass through of the investment credit.

I thank you.

Chairman Stark. Thank you, Mr. Stevenson.

Did the Bruderhof grow out of the Catholic religion in Germany or Lutheran or what?

Mr. Stevenson. No. Independently, separately.

Chairman Stark. Independently, OK.

Mr. Huffaker. Jacob Huter was martyred in the 16th century and the Huterites have been persecuted by the Catholics and Lutherans, whoever was in power at the moment, but it was Hitler who finally chased them out.

But they are very close to the Mennonites in theology. In conclusion, Mr. Chairman, we don't see an unfair advantage in providing the ITC, we see removal of what was really an unintended disadvantage.

There are very few of these communities, they are small, don't represent big dollars, don't have a regular congressional presence, we think it was basically an oversight and I am pleased to announce that Mr. Foley will be submitting a statement for the record, also former Governor Brown of California will be submitting a statement for the record.

I am pleased to announce that Mr. Foley is going to reintroduce the bill next year and we hope that all who are cosponsors this year will again cosponsor if we are not so fortunate to get it through this Congress. Thank you very much.

Chairman Stark. Thank you, Mr. Huffaker.

If I understand this, of the approximately—how many societies would fall under this particular provision? How many communities are there in the United States?

Mr. Huffaker. I asked IRS some time ago, and they told me 75. Someone else has indicated a few more. But that is the range.

Chairman Stark. Do they all, from time to time, or regularly, pay taxes? Or do some just break even year after year after year?

Mr. Huffaker. If you only break even, there would be no way to feed the members. Part of this, with both the Hutterite community and the Trappist community, they are not living on charity; they must support themselves.

Since your personal living expenses are not deductible, you have got to be making money in order to feed yourself and house yourself and clothe yourself.

So, yes, it is quite possible it may not make enough money to reach out and help others. But on a regular basis, they are going to be at least self-supporting.

Chairman Stark. That was my question.

First of all, I commend you all for your basic philosophy. And also I am sorry that it is necessary for you all to make this journey. I am sure there are more productive things you could be doing today. But, for the Chair's part, your testimony falls on receptive ears. It is a bill which enjoys much support in the committee, and my hope is that we can pass it.

I must say there is a chance many of us on the committee might like to eliminate the investment tax credit altogether, which would be another way of solving your problem. Although I might say, concomitant with that, we would lower your tax rates. Again, I am not sure that is as desirable to you, but that might indeed be another result.

We await the Treasury's submission to us of a plan later this year or next year, whichever Treasury it may be or under whichever administration it may be, for some type of tax reform. And that may be another way of solving it.

But I assure you that it would be my intention at the proper time in the next Congress, if I am fortunate enough to return, that we would like to look at this issue.

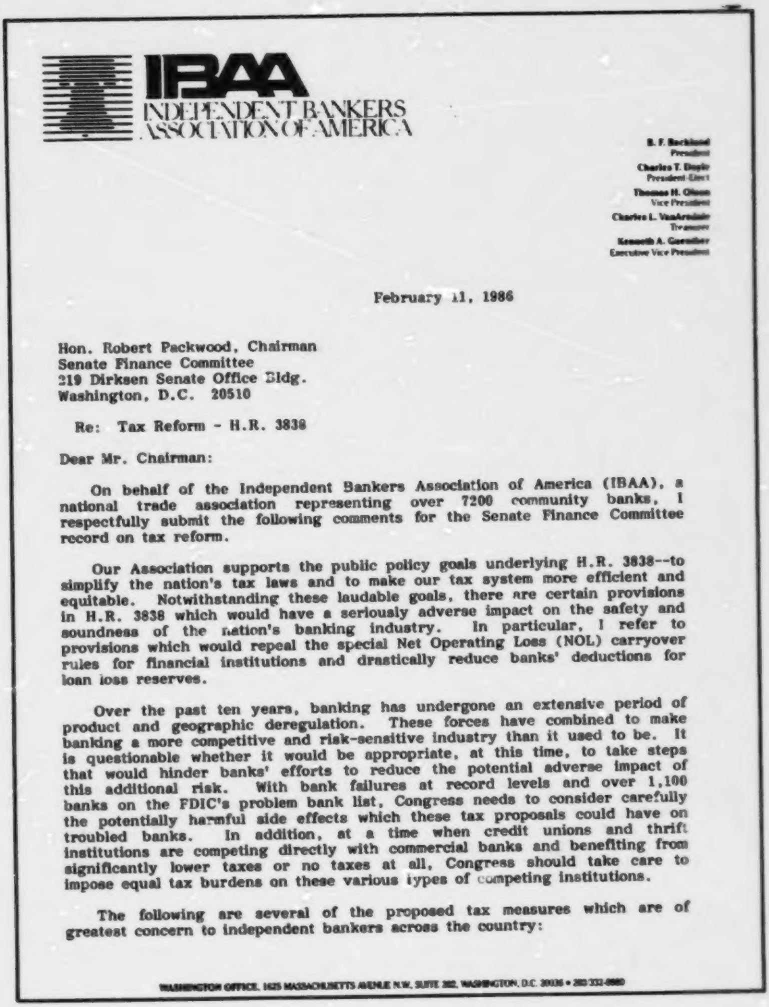
Mr. Duncan.

Mr. Duncan. Thank you, Mr. Chairman.

I want to thank you for being here. In fact, the chairman mentioned you coming a long distance to be with us. But let me say, I understand your problem much greater by you being here personally than I would have just by reading about it. You have been most helpful, and I look forward to some help being afforded you folks in the next year, anyway.

Mr. Huffaker. Thank you very much.

H.R. 1723 incorporates the technical amendment discussed in the testimony relating to the limitation of the provision to communities. We respectfully urge that the substance of H.R. 1723 be added to the Technical Changes.



IBAA
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Charles L. VanArsdale
Treasurer
Kenneth A. Guenther
Executive Vice President

February 11, 1986

Hon. Robert Packwood, Chairman
Senate Finance Committee
219 Dirksen Senate Office Bldg.
Washington, D.C. 20510

Re: Tax Reform - H.R. 3838

Dear Mr. Chairman:

On behalf of the Independent Bankers Association of America (IBAA), a national trade association representing over 7200 community banks, I respectfully submit the following comments for the Senate Finance Committee record on tax reform.

Our Association supports the public policy goals underlying H.R. 3838--to simplify the nation's tax laws and to make our tax system more efficient and equitable. Notwithstanding these laudable goals, there are certain provisions in H.R. 3838 which would have a seriously adverse impact on the safety and soundness of the nation's banking industry. In particular, I refer to provisions which would repeal the special Net Operating Loss (NOL) carryover rules for financial institutions and drastically reduce banks' deductions for loan loss reserves.

Over the past ten years, banking has undergone an extensive period of product and geographic deregulation. These forces have combined to make banking a more competitive and risk-sensitive industry than it used to be. It is questionable whether it would be appropriate, at this time, to take steps that would hinder banks' efforts to reduce the potential adverse impact of this additional risk. With bank failures at record levels and over 1,100 banks on the FDIC's problem bank list, Congress needs to consider carefully the potentially harmful side effects which these tax proposals could have on troubled banks. In addition, at a time when credit unions and thrift institutions are competing directly with commercial banks and benefiting from significantly lower taxes or no taxes at all, Congress should take care to impose equal tax burdens on these various types of competing institutions.

The following are several of the proposed tax measures which are of greatest concern to independent bankers across the country:

WASHINGTON OFFICE, 1625 MASSACHUSETTS AVENUE N.W., SUITE 202, WASHINGTON, D.C. 20036 • 202/332-8980

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NET OPERATING LOSS (NOL) CARRYOVER

Current NOL rules for financial institutions allow banks to apply net operating losses to their tax liability as far back as 10 years and as far forward as five years. The ability to "carry back" losses can often be the difference between continued operations and failure for a marginal bank. Community banks tend to lend heavily in their localities and therefore may have large exposure to a single economic sector that predominates in that region. When that sector experiences an economic downturn it can mean extraordinary losses for many banks in the region. Without sufficient tax carryovers, these losses can cause a bank to fail by reducing its capital below the regulators' minimum acceptable level.

For example, Bank A, a small IBAA member bank located on the western slope of Colorado with a majority of its loans concentrated in oil shale exploration and other natural resources, suffered a large net operating loss in 1982 of $1,671,301. The main reason for this loss was loans charged off as a result of a major oil corporation's withdrawal from oil shale activities in the region, which, in turn, was caused by depressed worldwide oil prices.

By utilizing the NOL provisions contained in current law, the bank was able to go back seven years to partially recoup the loss through a $737,402 tax refund (Exhibit I). The bank's ratio of primary capital to total assets without the loss carryback would have been approximately 3.6% (Exhibit II). The tax refund immediately improved the capital position of the bank and brought the primary ratio of capital to total assets to an acceptable 5.9% level. Thus, the 10-year net operating loss carryback provision in this case allowed the bank to convert its losses into earning assets immediately and to cushion the blow from a sizeable loss. It is highly likely that this bank would have been closed in 1982 due to a substandard capital ratio of 3.6%. However, because of the refund generated by the NOL carryback, the bank was able to stay open and today is a healthy, viable institution.

A second example is Bank B, an agricultural bank located in a western state, which suffered even more substantial losses in 1980. The bank lost $3,219,557 due to bad agricultural loans and customer fraud. As a result of the 10-year net operating loss carryback, the bank was able to offset $1,750,412 in losses, or 54.4% of the total loss it had suffered in a single year. This generated a tax refund of $702,299, and improved the bank's capital to assets ratio from 1.49 percent to 4.28 percent (Exhibit IV). What is interesting about this particular bank is that even the 10-year carryback provision was insufficient to make up for the remaining loss of $1,469,145, an amount which the bank may or may not have been able to recoup in additional NOL carry forwards over the next five years. As in the first example, the NOL provision enabled this bank to meet the regulator's minimum capital requirements which, in turn, helped the bank to obtain new financing and remain open.

These examples illustrate some of the advantages of the 10-year loss carryback provision by producing the following results:

a) Net operating loss carrybacks immediately
generate current tax benefits to banks by
providing direct cash flow and improving their

ratio of primary capital to total assets. In this way, the 10-year carryback period is far more beneficial than a carry forward period of 10 years;

b) By converting the tax benefit from a loss carryback to earning assets, there is an increase in the revenue-earning capacity of banks and their potential taxable income in the future;

c) Without the loss carryback provision, small banks across the country would not have the necessary tax cushion or reserve against large unforeseen losses that occur in a particular tax year.

It is imperative that the 10-year net operating loss carryback period be maintained, especially for agricultural banks. The present condition of the agricultural economy in the Midwest and Rocky Mountain regions could result in an avalanche of loan losses for agricultural banks due to a decrease in land values pledged as collateral on loans. Without the special NOL rules, the credit crisis in these areas will undoubtedly worsen.

In fact, the current law on NOLs is inadequate to provide the kind of "stretch-out" period needed by agricultural banks. The Senate Committee on Banking, Housing and Urban Affairs has properly recognized the need for additional help by agreeing to schedule hearings in March, 1986, on regulatory and legislative steps which would enable banks to amortize their agricultural loan losses over an extended period of time rather than being forced to recognize their entire losses in a single year. It would be inconsistent and counterproductive for the government to assist agricultural lenders and farmers with this or other "workout" measures while, at the same time, restricting commercial banks' use of similar NOL provisions.

The revenue implications of this provision are very small. According to the Ways and Means Committee report on H.R. 3838, repeal of the NOL rules for financial institutions would increase government receipts by less than $5 million annually. This cost would be more than offset by the cost of closing down marginal banks that might not be able to survive without the current NOL carryback provisions.

LOAN LOSS RESERVES

The ability of financial institutions to reserve funds against possible loan losses is equally vital to the safety and soundness of the banking industry. These reserves also have a direct impact on the financial system as a whole. Without such reserves, banks would be in a much weaker position to withstand sudden losses and widespread recession. Without this "insurance" against large losses, our national economy would be weakened.

Historically, the federal tax laws have recognized the unique importance of banks' loan loss reserves by allowing them to use the "percentage method" to calculate the allowable deduction. Over the past 10 years, the maximum percentage allowed under this method has declined, and now stands at only 0.6 percent of eligible loans in 1986 and zero percent after December 31, 1987.

Total elimination of the percentage method would constitute one of the most short-sighted and reckless tax "reforms" that Congress could enact and might eventually have widespread adverse economic consequences. We already find that the current 0.6 percent level is serving as a distinct disincentive for financial institutions to maintain healthy levels of loan loss reserves. Furthermore, at a time when the banking agencies are encouraging banks to boost their overall capital ratios and to increase loan loss reserves, it is inconsistent for the Treasury Department to be moving in the opposite direction by making it more costly and burdensome for banks to maintain these reserves.

The IBAA strongly supports retention of the percentage method for community banks. In addition, we favor an increase in the currently allowable deduction to a level more in line with regulatory requirements and the establishment of a permanent fixed percentage which doesn't change with each new Congress.

Under H.R. 3838, the reserve method of accounting for loan losses would be repealed for all banks over $500 million in assets but retained for all banks under that size. We would like to see the percentage method retained for all banks, regardless of size, at a higher level than the current 0.6 percent. However, with so many smaller banks in our agricultural heartland suffering severe economic stress, it is absolutely essential that, at a minimum, the nation's smaller banks be allowed to continue using the reserve method provided for in the House bill. It is only fair that community banks should be granted such latitude, since they have historically paid a significantly higher effective tax rate than the money center banks.

DENIAL OF DEDUCTION FOR CARRYING TAX EXEMPT BONDS

Under current law, banks holding tax-exempt municipal securities are denied a deduction for 20% of the interest expense attributable to carrying such securities. H.R. 3838 increases this disallowance to 100% but adds a temporary "small issue" exemption. Under this exemption, "public purpose" bond issues of $3 million or less, sold by an issuer who offers no more than $10 million in tax-exempt bonds in a single year, could be sold to banks that are licensed to do business in the state of the issuer. Under these limited circumstances, the bonds would be eligible for the 20% denial instead of 100%. This exemption would expire after three years.

The IBAA is concerned that such a disallowance signals a back-door attempt to tax banks' purchases of traditionally tax-exempt bonds. Tax-exempt bonds are vital to municipalities, which market a large percentage of their bonds to commercial banks. Denying the tax-exempt status of bonds held by banks will reduce banks' participation in this market. If that happens, yields on tax-exempts will rise, causing municipalities' cost of financing public projects to increase substantially.

Municipal securities have traditionally been exempt from federal taxation and the IBAA urges that this principle be retained in any tax reform package. However, we do realize the predicament of the small towns in

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America that may not be able to float a bond issue at any cost if local banks are not able to buy at least part of the issue. We therefore also recognize that the small issue exemption, if made permanent, would serve to reduce the adverse impact of this provision on rural communities. An even better solution, which would not cost much in terms of lost revenue, would be to exempt any public purpose bond from the 100% tax when purchased by a bank with under $500 million in assets

H.R. 3838 is particularly unfair because it changes the tax-exempt status of municipal securities already held by banks. The House bill applies to all bonds acquired after the effective date contained in the bill. This is unfair because it changes the rules in mid-stream. Hundreds of banks bought these bonds with the expectation that they could sell them to other banks if they needed to. Therefore, the effective date language should be changed to "issued after" instead of "acquired after." Purchasers of bonds issued after the effective date would be certain of the tax consequences attendant upon their purchase.

CASH-ACCRUAL ACCOUNTING

The House bill requires all businesses to report on an accrual basis, except for small businesses with under $5 million in "gross profits." These small businesses, including banks, can continue to use cash accounting. The IBAA urges that this exemption for small banks be retained in the Senate bill.

We estimate that roughly half of all small banks use the cash method for tax reporting purposes. This is done for several reasons. First, it is simpler and involves far less paperwork and accounting costs. Second, it serves as another mechanism by which small banks can plan for possible loan losses in the future and recognize income when they can best afford it.

For example, Bank C is an $18 million bank located near Peoria. During the last few years, there have been 28,000 jobs lost in the Peoria area as a result of closed plants and layoffs at Pabst, Heister, Wabco, International Harvester, Caterpillar Tractor Company, and Hiram Walker. Real estate values declined rapidly as 6000 homes flooded the marketplace when the unemployed work force could not make their payments. Bank C had an excellent track record in lending until 1980, as shown in Exhibit V. Since 1980, loan losses have exceeded $575,000. Losses in each of the last two years have exceeded 2% of outstanding loans, which is well above the national average.

Bank C's management had been aggressive in using tax planning in this small bank over several years to anticipate this type of unavoidable risk. As you can see from the attached Exhibit V, loan losses increased almost ten times from 1979 to 1985. By using the cash method of accounting over several years, the bank had deferred $163,000 by 1985, an amount which helped the bank weather its large losses in 1984 and 1985. If the bank had been compelled to use the accrual method, none of this $163,000 would have been available as a cushion and, when added to other large losses, might have caused the bank to fail.

INDIVIDUAL RETIREMENT ACCOUNTS

The House bill severely cuts back the availability of IRAs by linking the maximum amount that an individual can contribute to an IRA to the maximum amount that he or she has contributed to a 401K plan. Simply put, once someone contributes $2,000 to a 401K plan, he or she loses the opportunity to contribute any additional amount to an IRA during that year.

The IBAA opposes this limitation. IRA accounts are currently available to all taxpayers regardless of the fringe benefits (e.g. 401K plans) that they receive from their employers. The issue of taxation of fringe benefits should be kept separate and distinct from such individual savings devices as IRAs. With the personal savings rate in America at an all-time low, the IBAA urges the Committee to increase, not decrease, the amount of permissible contributions that taxpayers can make to their IRAs.

CREDIT UNION TAXATION

H.R. 3838 leaves intact the tax-exempt status of credit unions. The IBAA strongly believes that this is an inequity that should be rectified. Credit unions, which have had broad bank-like powers since 1980, present strong and unfair competition to banks--particularly small banks--because they pay no taxes and are not subject to the same regulatory requirements which banks must satisfy.

Credit union charters are now being granted on the basis of a geographic area rather than any common bond. Why should people who simply live within 50 miles of each other get a special tax break? These credit unions are advertising for, and getting, the accounts of the general public. If credit unions are going to act like banks, it is unfair that they should be tax exempt.

Thank you for your consideration of the views of thousands of community banks and their investors throughout the country. If you have any questions about any portion of this letter, please do not hesitate to contact us.

Sincerely,

B.F. Backlund
President

BFB/sld

cc: Members of the Senate Finance Committee

Bank A
Actual Tax Refunds From the 10-Year Net Operating Loss Carryback

EXHIBIT I

	Federal Taxable Income	Federal NOL Carryback	Tax Refunds Federal
1969	$ 27,295		$ 1,150*
1970	47,295		373*
1971	55,947		713*
1972	97,270	$ (97,270)	39.735
1973	88,612	(88,612)	37,161
1974	223,887	(223,887)	101,753
1975	119,263	(119,263)	43,708
1976	62,563	(50,778)	14,087
1977	314,199	(314,199)	136.435
1978	528,459	(528,459)	225,703
1979	618,743	(248,833)	136,584
1980	804,830		
1981	1,456.151		
1982	(1,671,301)	1,671,301	
Total federal tax refund			$737.402

* Investment tax credits carryback.

Bank A
Statement of Condition
1982

EXHIBIT II

	Before Tax Loss Carryback	Tax Refunds	Balance
Cash and cash in banks	$ 3,023,611	$821,440	$ 3,845,051
Investment securities	5,717,670		5,717,670
Loans	24,000,117		24,000,117
Property and equipment	878,958		878,958
Other assets	669,644		669,644
	34,290,000		35,111,440
Deposits	32,683,735		32,683,735
Other liabilities	368,975		368,975
Capital	250,000		250,000
Surplus	250,000		250,000
Undivided profits	737,290	821,440	1,558,730
	$34,290,000		$34,111,440
Capital to assets ratio	3.608%		5.863%
Taxable Loss	$(1,671,301)		

Bank B
Actual Tax Refunds From the 10-Year Net Operating Loss Carryback

EXHIBIT III

	Federal Taxable Income	Federal NOL Carryback	Tax Refunds Federal
1967	N/A		
1968	$ 41,234		$ 26
1969	56,629		1,331
1970	141,264	$ (141,264)	61,203
1971	174,029	(174,029)	76,967
1972	146,365	(146,365)	61,625
1973	187,685	(187,685)	83,283
1974	169,161	(169,161)	73,981
1975	101,027	(101,027)	31,473
1976	118,432	(118,432)	42,262
1977	204,809	(204,809)	78,846
1978	190,705	(190,705)	73,169
1979	316,935	(316,935)	118,133
1980	(3,219,557)	1,750,412 (1)	
		1,469,145 (2)	
Total federal tax refund			$702,299

(1) Used
(2) Carryover to 1985

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Bank B
Statement of Condition
1980

EXHIBIT IV

	Before Tax Loss Carryback	Tax Refunds	Balance
Cash and cash in banks	$ 4,773,050	$807,389	$ 5,580,439
Investment securities	5,712,384		5,712,384
Loans	16,001,206		16,001,206
Property and equipment	217,522		217,522
Other assets	1,013,649		1,013,649
	27,717,811		28,525,200
Deopsits	26,953,317		26,953,317
Other liabilities	349,676		349,676
Capital	500,000		500,000
Surplus	1,000,000		1,000,000
Undivided profits	(1,085,182)	807,389	(277,793)
	$27,717,811		$28,525,200
Capital to assets ratio	1.496%		4.28%
Taxable Loss	$(3,219,557)		

EXHIBIT V

	Actual Loss	Average Loans Outstanding	Percentage of Loss	Total Assets
1975	$ 10,379	$2,798,228	.37%	$ 7,373,603.34
1976	10,350	3,067,315	.34%	8,009,212.12
1977	12,860	4,186,139	.31%	8,586,167.57
1978	12,346	4,804,659	.26%	9,504,806.78
1979	14,127	5,191,335	.27%	10,952,375.07
1980	48,879	5,276,445	.93%	11,330,866.35
1981	89,073	5,187,471	1.72%	13,265,532.12
1982	68,344	5,226,804	1.31%	14,482,364.32
1983	51,865	6,774,189	.77%	19,386,462.30
1984	158,694	7,373,582	2.15%	17,877,547.63
1985	161,698	6,881,833	2.35%	19,310,667.31

TESTIMONY

OF

BOB SMUCKER
Vice President, Government Relations
INDEPENDENT SECTOR

on

The Impact of the President's Tax Proposals on Charities

Submitted to the
Senate Finance Committee
February 20, 1986

FULL TESTIMONY OF BOB SMUCKER

Introduction

I am Bob Smucker, Vice President for Government Relations, of INDEPENDENT SECTOR, a membership organization of 607 national voluntary organizations, foundations, and business corporations which have banded together to strengthen our national traditions of giving, volunteering, and not-for-profit initiative. A list of our members is attached.

Our Voting Members are organizations with national interest and impact in philanthropy, voluntary action, and other activity related to the independent pursuit of the educational, scientific, health, welfare, cultural and religious activities of the nation. The range of members includes the American Heart Association, United Negro College Fund, Goodwill Industries of America, Kellogg Foundation, National Council of Churches, Native American Rights Fund, Association of Junior Leagues, CARE, Council on Foundations, American Association of Museums, Council of Jewish Federations, National Puerto Rican Coalition, National Conference of Catholic Charities, National Audubon Society, Equitable Life Assurance Society of the U.S., National Association of Independent Colleges and Universities, United Way of America, Brookings Institution, American Enterprise Institute, Appalachian Mountain Club, and the American Red Cross. The common denominator among this diverse mix of organizations is their shared determination that the voluntary impulse shall remain a vibrant part of America.

The History of Tax Policy in Relation to Charitable Giving

Historically, tax policy has encouraged voluntary initiative. From the beginnings of our country, deliberate effort has been made to encourage private initiative for the public good and to promote and sustain the voluntary institutions through which the nation does so much of its public business. Those conscious efforts included the property tax exemption and, when the modern day Federal income tax was adopted, the charitable contributions deduction.

The action of Congress in 1917 to provide for the charitable contributions deduction was a clear indication that the nation wanted to find every conceivable way to encourage pluralism and maximize involvement of citizens in addressing their own problems and aspirations. When Congress extended the deduction for nonitemizers in 1981, it was further indication that it is the position of the American people and our government that all of us should be encouraged in every way possible to support the causes of our choice.

The Charitable Deduction for Nonitemizers

A law of major importance -- to society at-large, to the 800,000 public charities and to the 62 million taxpayers who do not itemize their income tax -- was enacted in August 1981, as a part of the 1981 Tax Act. That measure, the Charitable Contributions Law, allows a taxpayer to take a deduction for contributions to charity even if the giver takes the standard deduction. According to recent research, the law will generate between $5 and $6 billion annually in increased contributions to charities.

In the face of rising federal deficits, the philanthropic community agreed when the law was first enacted, in 1981, to a phase-in of the charitable deduction for nonitemizers.

1982 -- 25 percent of 1st $100 (maximum of $25)
1983 -- SAME
1984 -- 25 percent of 1st $300 (maximum of $75)
1985 -- 50 percent of all contributions
1986 -- 100 percent of all contributions

Dr. Lawrence B. Lindsey, an economist with Harvard University and the National Bureau of Economic Research, estimates that the charitable deduction for nonitemizers will increase contributions by $5 to $6 billion per year, if the deduction is made permanent at a 100 percent level with no floor or other limitations.

The charitable deduction for nonitemizers will expire at the end of 1986, unless Congress acts to make it permanent. Thirty-nine Senators now cosponsor S. 361 which would make the measure permanent. And H.R. 3838, passed by the House, also makes the charitable deduction for nonitemizers permanent, but with a $100 floor.

It is important to clarify how the charitable deduction for nonitemizers generates substantially increased giving. People give to charities based on generosity to and sacrifice for causes and organizations in which they believe. The tax deduction is not the reason for donating, but it does prompt taxpayers to give more than they otherwise would. Charitable deductions offer an incentive to donors to increase the size of their gifts. An April 1985 door-to-door survey of 10,000 households by the American Cancer Society provides the most recent practical evidence that the charitable deduction for nonitemizers increases the size of one's gift. The survey found that those who received information about the charitable deduction for nonitemizers gave an average of 10 percent more than those who did not.

Impact of $100 Floor on Giving by Nonitemizers

INDEPENDENT SECTOR is extremely grateful that the House tax reform legislation extends a permanent charitable deduction to nonitemizers, and we urge this Committee to do the same. Preserving a full charitable deduction for nonitemizers becomes even more critical under H.R. 3838, because the percentage of nonitemizers would be dramatically increased. Dr. Lindsey estimates that, in 1986, the percentage of nonitemizers would increase from 58 percent under current law to 75 percent under H.R. 3838. Limiting this deduction -- which contributes so much toward the ability of charities to perform their services to the public, and which recognizes the voluntary sacrifice of three-quarters of all taxpayers -- would be terribly unfair.

Unfortunately, H.R. 3838 includes a $100 floor on charitable gifts of nonitemizers. The $100 floor was enacted to reduce the cost of the nonitemizer deduction to the Treasury. It was not the result of an effort to pursue the best possible government policy to encourage charitable contributions for public purposes.

There are a number of problems with the $100 floor, which is opposed by INDEPENDENT SECTOR.

1. FLOORS INCREASE.

-- Floors on tax deductions are often increased. For example, the three percent floor (3% of adjusted gross income) on medical deductions has been increased to five percent. The $100 floor on the casualty deduction has been increased to 10 percent of adjusted gross income. Both represent substantial increases over the original floors.

-- Research by Dr. Larry Lindsey shows that a doubling of the $100 floor would cause a fivefold increase in the amount charities would lose as a result of the increased floor. A triple increase in the floor would cause an eightfold increase in the amount charities would lose.

-- There is no reason to believe that once enacted, efforts would not be made to increase the floor on the charitable deduction, substantially.

2. FLOORS CAN BE EASILY EXPANDED.

-- Once a floor is enacted, it is much easier to expand it. The U.S. Treasury has already proposed that the Senate Finance Committee consider extending the $100 floor on nonitemizers to all taxpayers.

3. THE FLOOR ON THE CHARITABLE DEDUCTION SERVES NO IMPORTANT PUBLIC PURPOSE.

   -- Charitable contributions are tax deductible because they serve public purposes. There is no reasonable public policy justification for disallowing the first $100 of charitable contributions since those contributions also serve public purposes.

4. THE FLOOR SHOULD NOT BE USED BY THE U.S. TREASURY AS AN AUDITING MECHANISM.

   -- One reason the U.S. Treasury supports a floor is to avoid having to audit those tax returns from nonitemizing taxpayers who give less than $100. It is true that the $100 floor would simplify the auditing process. However, it is not fair to ask taxpayers to bear the burden of that simplification.

   Instead of supporting a floor to make auditing easier, IS has recommended to the Internal Revenue Service, Treasury, and to Congress that they require taxpayers to provide detailed information regarding their contributions, with their tax return. This would provide reasonable assurance that charitable deductions claimed are accurate. Both Treasury and the Internal Revenue Service have rejected this proposal.

A full charitable deduction is a much wiser and fairer tax policy, and one which we hope the Senate Finance Committee will pursue.

Gifts of Appreciated Property

INDEPENDENT SECTOR also opposes H.R. 3838's inclusion of gifts of appreciated property in the alternative minimum tax. We urge this Committee to maintain current law which permits a full deduction for gifts of appreciated property. Current tax law draws no distinction between gifts of cash and gifts of property.

Both receive a deduction, which encourages contributions to public purposes. The many public purposes enhanced by gifts of appreciated property include endowments for medical research, funds for hospital and university buildings, scholarships for low income students, and support for community arts groups. A tax policy that encourages these assets permits the sector to better meet present and future human needs.

Including gifts of appreciated property as a tax preference item in the alternative minimum tax increases the cost of giving from 30 cents on the dollar under current law to 78 cents on the dollar under H.R. 3838 (Larry Lindsey, January 22, 1986). Faced with this extraordinarily high cost of giving, the taxpayer will probably keep the asset or pass it to his heirs. INDEPENDENT SECTOR hopes that the Senate Finance Committee would favor a tax code which encourages the distribution of wealth for public purposes, rather than the accumulation of wealth for private gain.

Preserving the treatment of gifts of appreciated property under current law not only serves the public good, but it does so in a cost effective manner. Under H.R. 3838, charities would lose approximately $570 million while Treasury would gain only $334 million.

Finally, the percentage limitation on gifts of appreciated property and recent substantiation rules required under current law, assure that these gifts are not responsible for tax avoidance. Taxpayers cannot avoid their tax obligation by donating appreciated property due to the deductibility limit of 30 percent of adjusted gross income. According to a Treasury study for the Ways and Means Oversight Subcommittee, gifts of appreciated property and other itemized deductions are not significant factors in tax avoidance by high income taxpayers. Maintaining current law for these gifts would, therefore, not jeopardize the minimum tax.

In addition, beginning in 1985, strict IRS appraisal and substantiation rules apply to property gifts valued over $5,000. Although publicly traded securities are exempted from this qualified appraisal requirement, they are included in the detailed reporting requirements imposed on noncash gifts in excess of $500. Therefore, greater substantiation and less tax avoidance is guaranteed under existing rules.

Private Giving and the Impact of the Federal Budget on Nonprofit Organizations and the People They Serve.

The impact of Federal budget cuts on human services makes encouraging charitable giving, through tax incentives, all the more important.

During the four year period 1982-85, Federal budget cuts in the funding of human services totaled $50 billion, exclusive of funding for Medicare and Medicaid. The largest cuts were in social welfare, including $6.8 billion for social services, $24.7 billion for employment and training, and $9.2 billion for community development. Funding for education and research, arts and culture, and environment also decreased during that period.

According to preliminary figures from the Urban Institute, based on their analysis of the President's 1987 budget proposal, the 1987 budget cuts will be even greater than previous years.

What makes these changes in federal funding especially important to nonprofit and charitable organizations is not simply that they affect the levels of need that exist in our society and therefore the demands that are placed on charitable resources. Equally important is the fact that they affect the revenues of nonprofit organizations and therefore their ability to serve those in need. In recent years, government has turned more and more to private, nonprofit institutions to help deliver publicly-financed services. Now with the sharp cuts, many, including those in government, will look even more to charities to fill the gap. Unfortunately, private giving simply can't make up the difference. In fact, private giving has been able to make up for only 17 percent of the revenue losses from Federal budget cuts of nonprofit organizations, and only 5 percent of the overall cuts in human services.

Public Support for Charitable Deductions

Two public opinion polls demonstrated strong support for retaining charitable deductions in tax reform law. A January 1985 New York Times/CBS News poll showed that 81 percent believed that people should get the charitable deduction. A more recent Los Angeles Times poll supported keeping the deduction for giving to charity by an overwhelming 82 percent. Even among those who do not claim charitable deductions, 70 percent favored keeping the tax incentive, suggesting they think its social value outweighs their personal interest. The findings of both polls are consistent with a November 1984 Gallup survey, in which 80 percent of those queried stated that any tax reform proposal should either maintain the current charitable contributions deduction, or increase it.

Conclusion

The overall impact of the Tax Reform Act of 1985 on the charitable community is a reduction of $3.14 billion in 1986 giving. This represents a decline of 4.6 percent from the amount which would be given to charities under current law. Much of that reduction is the unintended consequence of lowered marginal tax rates, which INDEPENDENT SECTOR does not oppose. We do oppose the $100 floor on the nonitemizer deduction and the alternative minimum tax treatment of appreciated property gifts in H.R. 3838. These two provisions represent a decline of $731 million or some 23 percent, of the total decline of giving under the Tax Reform Act of 1985.

We urge this Committee to include a full charitable deduction for nonitemizers and current law treatment of gifts of appreciated property in the Senate tax reform legislation. Such action maintains governmental encouragement of voluntary endeavor. Any tax measure which might stifle voluntary initiative would negate the larger public policy consideration which, from the start, has been to foster the vast participation and diversity that are so much a part of America's uniqueness.

For a country -- and an Administration and Congress -- that wants to encourage private initiative for the public good, full deductibility of both cash and noncash gifts is mandatory. It signals to the public, that the government recognizes the participation of all taxpayers in serving public purposes.

The issue comes down to what kind of society we want to be and a resolve to use public policy to encourage that vision. If pluralism is part of that ideal, then it is absolutely essential to search out every possible way to encourage it. The deduction of charitable gifts has provided a significant incentive for increased giving, but even more important has served to remind all of us that it is the philosophy and policy of the people and our government, that giving is an act for the public good that is to be fostered.

These direct and indirect encouragements have helped to build the enormous degree of pluralism and citizen participation that are among the country's most important characteristics. Retaining a full deduction for gifts of appreciated property and making the charitable deduction for nonitemizers permanent without a floor represents a step toward a more caring and participatory population.

Charities are willing to accept the decreased charitable giving that will result from lowered marginal tax rates. We are struggling to meet an increased demand for services as direct federal support to some subsectors of the independent sector is being reduced. We cannot accept the imposition of a floor on the charitable deduction for three out of four taxpayers, nor the inclusion of appreciated property gifts in the alternative minimum tax.

02/20/86

INDEPENDENT SECTOR VOTING MEMBERS (AS OF 02-20-86)

ACCION International/AITEC
ALS Association
ASPIRA of America
AT&T Foundation
Accountants for the Public Interest
Aetna Life and Casualty Company
Aga Khan Foundation U.S.A.
Aid Association for Lutherans
Alcoa Foundation
Alliance of Independent Colleges of Art
Allied Corporation
Allstate Foundation
American Arts Alliance
American Assembly
American Association for Higher Education
American Association for the Advancement of Science
American Association of Fund-Raising Counsel, Inc.
American Association of Homes for the Aging
American Association of Museums
American Association of University Women
American Can Company Foundation
American Cancer Society
American Citizens Concerned for Life
American Council for Judaism
American Council for the Arts
American Council on Alcoholism
American Council on Education
American Dance Guild, Inc.
American Diabetes Association, Inc.
American Ditchley Foundation
American Enterprise Institute for Public Policy Research
American Express Foundation
American Farmland Trust
American Foundation for the Blind, Inc.
American GI Forum National Programs Administration
American Heart Association
American Hospital Association
American Humanics, Inc.
American Leadership Forum
American Library Association
American Lung Association
American Near East Refugee Aid
American ORT Federation, Inc.
American Public Radio
American Red Cross
American Social Health Association
American Standard Foundation
American Stock Exchange, Inc.
American Symphony Orchestra League
American Woman's Economic Development Corporation
Americans for Indian Opportunity
Amoco Foundation, Inc.
Anschutz Family Foundation
Appalachian Mountain Club
Arca Foundation

INDEPENDENT SECTOR VOTING MEMBERS (AS OF 02-20-86)

Armco Foundation
Arrow, Inc. (Amer. for Restitution, Righting of Old Wrongs)
Art Museum Association
Arthritis Foundation
Arts International
Aspen Institute for Humanistic Studies
Association for International Practical Training
Association for Volunteer Administration
Association of American Colleges
Association of American Universities
Association of Art Museum Directors
Association of Black Foundation Executives
Association of Governing Boards of Universities & Colleges
Association of Hispanic Arts Inc.
Association of Independent Conservatories of Music
Association of Jesuit Colleges & Universities
Association of Junior Leagues
Association of Professional Vocal Ensembles
Association of Voluntary Action Scholars
Atlantic Richfield Foundation
Avon Products Foundation, Inc.
B'nai B'rith International
Mary Reynolds Babcock Foundation
Leo Baeck Institute, Inc.
Ball Brothers Foundation
BankAmerica Foundation
Bankers Trust Company
Beatrice Companies, Inc.
Bell Atlantic
BellSouth
Benton Foundation
Best Products Foundation
Bethlehem Steel Corporation
Big Brothers/Big Sisters of America
Bing Fund Corp.
Blandin Foundation
Boeing Company
Borden Foundation
Boston Foundation
Boston Globe Foundation, Inc.
Botwinick-Wolfensohn Foundation
Boy Scouts of America
Boys Clubs of America
Bread for the World Educational Fund, Inc.
Otto Bremer Foundation
Bristol-Myers Fund, Inc.
Brookings Institution
Brother's Brother Foundation
Burroughs Corporation
Burroughs Wellcome Fund
Edyth Bush Charitable Foundation, Inc.
Business Committee for the Arts, Inc.
CARE
CBS Inc.
CEIP Fund, Inc.

INDEPENDENT SECTOR VOTING MEMBERS (AS OF 02-20-86)

CIGNA Foundation
CODEL - Coordination in Development Inc.
CPC International, Inc.
Cabot Corporation Foundation
California Community Foundation
Call for Action, Inc.
Camp Fire, Inc.
Career Training Foundation
Carnegie Corporation of New York
Carnegie Foundation for the Advancement of Teaching
Carter Hawley Hale Stores, Inc.
Catalyst for Women, Inc.
Caterpillar Foundation
Center for Corporate Public Involvement
Center for Creative Leadership
Center for Creative Management
Center for the Study of the Presidency
Champion International Corporation
Chase Manhattan Bank, N.A.
Chesebrough-Pond's Inc.
Chevron U.S.A., Inc.
Child Care Action Campaign
Children as Teachers of Peace Foundation, Inc.
Children's Aid International
Christian Church Foundation
Christian Ministries Management Association
Church Women United
Citicorp (USA), Inc.
Citizens' Scholarship Foundation of America
Cleveland Foundation
Clorox Company Foundation
Close Up Foundation
Coca-Cola Foundation
College Board
Colonial Williamsburg Foundation
Columbia Foundation
Committee for Food and Shelter
Commonwealth Fund
Congressional Award Foundation
Congressional Black Caucus Foundation, Inc.
Conoco, Inc.
Consortium for the Advancement of Private Higher Education
Corning Glass Works Foundation
Coro Foundation
Corporation for Enterprise Development
Council for Adult and Experiential Learning
Council for American Private Education
Council for Financial Aid to Education
Council for the Advancement and Support of Education
Council for the Advancement of Citizenship
Council of Better Business Bureaus
Council of Jewish Federations
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I

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February 11, 1986

The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Building
Washington D.C. 20511

Dear Senator,

I have been in business in California since 1946 and we have enough problems without adding to them, the House passed version of a tax reform bill H.R. 3838.

The House passed version of the tax reform is anti growth and anti jobs. I would hope you in the Senate put your efforts on our nations number one problems, twin deficits and also budget and trade and set aside tax reform for the present.

I would also like my comments to be included in the hearing records.

Yours Truly,

B.B. Patterson
President
B.B.P./csw

C.C. The Honorable Pete Wilson
C.C. The Honorable Alan Cranston

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WRITTEN STATEMENT

SUBMITTED BY THE INTER-LOCAL PENSION FUND TO THE UNITED STATES SENATE COMMITTEE ON FINANCE FOR INCLUSION IN THE PRINTED RECORD OF HEARINGS ON H. R. 3838, THE TAX REFORM ACT OF 1986, JANUARY 29-FEBRUARY 6, 1986

This written statement is submitted by the Inter-Local Pension Fund of the Graphic Communications International Union, AFL-CIO, to the Committee on Finance of the United States Senate for inclusion in the printed record of hearings, January 29 through February 6, 1986, on the Tax Reform Act of 1986. The Inter-Local Pension Fund is seeking legislation confirming the deductibility of employee contributions to pension trusts exempt from taxation pursuant to Section 501(c)(18) of the Code.

Section 501(c)(18) Funds

Section 501(c)(18) exempts from taxation trusts created before June 25, 1959 and forming part of a pension plan, funded exclusively by contributions from employees, which meets specified qualifications. The Inter-Local Pension Fund is a Section 501(c)(18) fund, as determined by IRS qualification letter. Altogether there are only three or four other funds under Section 501(c)(18). Because Section 501(c)(18) is expressly limited to trusts created before June 25, 1959, no additional Section 501(c)(18) plans may be created.

Annual contributions by participants to all Section 501(c)(18) funds are estimated at approximately $25,000,000 per year.

The Inter-Local Pension Fund

The Inter-Local Pension Fund was established in 1950. Participants are members of local unions affiliated with the Graphic Communications International Union, AFL-CIO. The Fund is independently trusteed under a Trust Indenture which can only be changed by a vote of the participants. Participation in the Fund is mandatory for members in those local unions that have voted to participate. The members' level of participation is established by vote of the local union membership, from a minimum of $2.50 per week to a maximum of 4 percent of gross earnings.

The Inter-Local Pension Fund is a national fund, with net assets of over $300,000,000, over 18,000 contribution-paying members all over the United States, and individual contributions of approximately $17,750,000 annually. Over 6,300 retirees are now enjoying substantial monthly pension benefits from the Fund.

Contributions to the Fund are made exclusively by the individual employees. The average annual contribution of a participant is less than $1,000. No contributions are made by any employer. Benefits under the Fund include:

—A normal retirement benefit payable at age 60, in the form of a monthly payment for the rest of the retired member's life, in the amount of $3.75 per month for each $130 contributed to the Fund.

--An early retirement pension payable at or after age 55, reduced from the normal pension by 1/4 of 1 percent for each month between retirement and the member's 65th birthday.

—A spouse's pension in lieu of death benefit, which provides to eligible spouses at age 60 a monthly pension of more than one-half of the deceased participant's normal pension.

It is Congressional policy to encourage retirement savings by individuals in private plans. Individuals may do so through IRA accounts. Employee contributions into group plans sponsored by an employer through QVEC's are given the benefit of tax deferral. Employee contributions into group plans sponsored by an employer through cash or deferred plans qualified under Section 401(k) are given the benefit of tax deferral.

Section 501(c)(18) plans are group plans to which existing statutes accord the same recognition with respect to tax exemption for their income, but to which recent rulings of the IRS appear to have denied the benefit of the deferral for contributions which is currently given to employee contributions to group plans sponsored by employers. Section 501(c)(18) plans serve exactly the same social policy as the others, except that instead of being sponsored by an employer, they are made available to employees through their own organizations—a union or other employee group.

In instances, for example, where an employer chooses not to maintain a retirement plan, a 501(c)(18) plan, where one exists, may be the only means available to the employee to participate in a group retirement program funded by his or her own contributions. A denial of that opportunity merely because the plan is sponsored by an employee group rather than by the employer is essentially discriminatory and in conflict with Federal policy to encourage self-help retirement savings programs.

Special Features of the Inter-Local Pension Fund

The Inter-Local Pension Fund contains a number of features particularly consistent with Federal pension policy—and in some respects even more directly dedicated to promoting those policies than plans which now receive the benefit of tax-deferral for contributions. For example:

A. The Inter-Local Pension Fund is fully portable within the graphic arts industry. A participant may move from employer to employer and still continue his active participation in the Fund.

B. The Fund is truly a retirement fund. The Fund's benefit structure maximizes retirement benefits. No pension benefits are payable while a participant is working in the graphic arts industry. Unlike an IRA or other tax-deferred plans, a participant may not withdraw his money, even with a penalty, as long as he continues to work in the graphic arts industry either as an employee or in a direct supervisory capacity. Distributions are permitted only in case of retirement, disability or other termination of employment in the graphic arts industry.

C. Surviving spouses' pension rights are in most respects greater than those mandated under ERISA.

D. Participants in the Inter-Local Pension Fund are vested immediately upon participation. A participant who is no longer employed in the graphic arts industry at the time he terminates his participation in the Fund may fully vest his pension or receive a withdrawal benefit of the full return of contributions.

Prior Tax Treatment of 501(c)(18) Funds

This proposed legislation would re-establish what the IRS had expressly recognized for over 30 years and stated by Revenue Ruling—that individual contributions to funds like the Inter-Local Pension Fund are tax-deductible.

Since the Fund was founded in 1950 it was understood that employee contributions were deductible. This was confirmed in Revenue Ruling 54-190, making contributions deductible in the same fashion as union dues. However, in 1980, the IRS issued a private letter ruling denying a deduction to a participant in the Inter-Local Pension Fund. Subsequently, in Revenue Ruling 82-127, the IRS declared its earlier Revenue Ruling 54-190 obsolete, without explanation, but prospectively only. The Fund understands that some members in fact continue to deduct their contributions to the Fund, in reliance on Revenue Ruling 54-190, with mixed determinations by the IRS.

Impact of the Proposed Legislation on Federal Revenues

The impact of the proposed legislation on Federal revenues would be negligible:

—Total contributions from participants in all 501(c)(18) funds total only approximately $25,000,000 annually.

—By law, no new 501(c)(18) funds can be established.

—Many participants in 501(c)(18) funds are deducting their contributions, based on Revenue Ruling 54-190.

—The tax revenues will be substantially recovered in any event, since to the extent contributions are deductible the benefits received by participants will be fully taxable.

Thus, basic considerations of tax fairness and simplicity support the proposed legislation. It would confirm the long-standing IRS policy in effect since the Fund was founded (and only recently placed in question) that such contributions may be dedicated. It would eliminate the invidious discrimination between group plans sponsored by employers and those which for at least 26 years have been sponsored by the employees' own organizations. It would have negligible impact on Federal revenues, and it would permit at least this limited, long-recognized group to continue to have the benefit of tax deferral of contributions for their long-established retirement plans based on the very principles of self-help which national policy favors and seeks to encourage.

Submitted by

Inter-Local Pension Fund
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Chicago, Illinois 60607
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Washington, D. C. 20036
(202) 872-6700

February 11, 1986

I

STATEMENT OF THE
INTERNATIONAL ASSOCIATION OF INDEPENDENT
TANKER OWNERS
BEFORE THE COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE
ON H.R. 3838

This statement is submitted by the International Association of Independent Tanker Owners ("INTERTANKO") concerning the provisions of H.R. 3838 which relate to ocean transportation. INTERTANKO represents independent (non-oil company and non-state-owned) tanker owners of various nationalities, including American owners (of U.S.-flag and foreign-flag tonnage) in regard to technical, operational, environmental and economic conditions associated with the international movement of liquid cargoes in bulk. INTERTANKO performs research, provides assistance and advice to its members and to national administrations, and is an accredited non-governmental adviser to various United Nations organizations and public and private multinational groups. The chairman of INTERTANKO is James H. Rand (an American) who is Chairman of the Board and Chief Executive Officer of Marine Transport Lines of Seacaucus, New Jersey. INTERTANKO's administrative offices and permanent staff are located in Oslo, Norway. Members' vessels serve frequently in the foreign commerce of the United States, and would be directly and indirectly affected by the changes H.R. 3838 would make in the U.S. tax laws.

INTERTANKO's position is that certain of the proposed changes are ill-advised and should be either deleted or modified. They would not produce results beneficial to the U.S. public interest, and would not appreciably enhance tax revenues, especially in view of the administrative burdens which the proposed changes would create. In addition, the changes would adversely affect shipping in U.S. foreign commerce and would be detrimental to U.S. international commercial relationships which have been built, in part, on historical bases in maritime trading. INTERTANKO therefore urges rejection of (a) the proposed change in the "reciprocal exemption" rules, (b) the 4% tax on gross shipping income, (c) the 50%-50% sourcing rule for shipping income, (d) the repeal of the portion of Subpart F providing for tax deferral of reinvested income, and (e) the limitations on the "Capital Construction Fund."

I. INTERTANKO

INTERTANKO's interest in this matter lies in the extensive service which its members' vessels perform in U.S. foreign commerce. The membership of INTERTANKO is comprised of 260 privately owned companies from over 30 countries,[1] operating about 1300 tanker vessels of 140 million deadweight tons. Those vessels constitute more than half of the world's total tanker and combination vessel tonnage. Thus, INTERTANKO is a broadly based international shipping and commercial organization whose members make a substantial contribution to the carriage of goods (liquid cargoes in bulk) to and from the United States. In this way, INTERTANKO's members provide an important service to U.S. commerce and foreign trade. Shipping is, after all, the means by which most U.S. foreign trade is accomplished; any adverse intrusion, whereby shipping in U.S. trades is hampered or rendered less economical, will weaken competition and U.S. commerce will suffer. Moreover, as noted above, INTERTANKO's membership includes U.S. companies, and the burdens of the proposed tax changes would be doubly felt within the U.S.

Following below is a discussion of the proposed tax law changes and their harmful consequences.

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[1] Australia, Belgium, Bermuda, Canada, Chile, Cyprus, Denmark, Finland, France, Federal Republic of Germany, Greece, Hong Kong, India, Italy, Japan, Republic of Korea, Liberia, Luxembourg, Malaysia, Monaco, the Netherlands, Norway, Panama, Peru, Philippines, Saudi Arabia, South Africa, Spain, Singapore, Sweden, Switzerland, Turkey, United Kingdom, United States. INTERTANKO membership does not include oil companies or state-owned companies.

II. THE TAX LAW CHANGES

INTERTANKO, as noted, objects to several portions of H.R. 3838, but of particular concern is the one which would substantially change the current rules for "reciprocal exemption." This proposed change demonstrates the principal weakness contained in the several proposals: The provisions do not take sufficient account of the unique international aspects of ocean shipping and the need for responsiveness to accepted international shipping practices. Recognizing those important points will, INTERTANKO believes, lead to the rejection of the revised "reciprocal exemption" rules and income sourcing rules.

A. The Reciprocal Exemption

Current tax law (26 U.S.C. §§872(b)(1), 883(a)(1)) provides "reciprocal exemption" rules pertaining to income of foreign individuals and corporations derived from shipping. Foreign ship operators are exempt from U.S. taxation on U.S. source shipping income if the income arises from operation of a ship documented under the laws of a country which grants an equivalent exemption for shipping income of U.S. citizens and corporations, or does not tax such income. In determining the applicable foreign laws, one looks to the law of the country of documentation, or flag, of the ship generating income to its owner (vessel flag test).

The bill, H.R. 3838 (Section 613(c)), would continue the reciprocal exemption but eliminate the vessel flag test. The determining factor would instead be the law of the country where the individual ship owner resides or where the owning corporation is organized. In addition, the exemption would not apply if 25 percent or more of a corporate owner's shareholders resided in countries not providing the necessary equivalent exemption.

The proposed change in Section 883 would foretoken chaotic conditions in international shipping, and reverse the development of uniform national taxation of this international industry which moves the vast portion of international trade. The current version of Section 883 has been in effect for 65 years and has been a prominent factor in the guiding principle for taxation of shipping income from international commerce: that countries do not, for the most part (that is, except for a number of developing countries), tax the income produced by the foreign vessels which carry their trade. The encouragement and maintenance of such common practice has been a mainstay of U.S. tax policy, and no reason has been shown warranting a policy change. Shipping, while itself a service industry, facilitates trade.

Those principles are adhered to by all major trading countries and by most other nations. A drastic change in tax policy by the United States (the world's largest trading country) would set a precedent likely to have ramifications devastating to shipping, markedly raising its costs. It is important to recall that increases in such costs will eventually be passed on to the consumer, creating an inflationary effect and dampening consumer demand. Other nations, particularly those seeking short-term solutions to chronic economic ills, often without a broad, long-range view of international economic factors, would follow the U.S. lead and impose their equivalent taxes. Even countries which generally recognize long-term economic factors would have to resort to retaliation as the only means of protecting their shipping industry.

The result would be that the countries would assert the right to tax any leg of a voyage that touched their ports. The total income subjected to tax would most likely be far more than 100 percent of the voyage income, since each voyage leg would fall with the taxing authority of two countries. Voyages which include port calls in several countries constitute a common mode of operation, providing or enhancing the economic benefits of a voyage.

In addition -- and this goes to the heart of the problem -- each taxing country (including the United States) would be forced to engage in the process of analyzing the ownership structure of every vessel, and locating the owners to determine their nationality in order to obtain the appropriate measure of reciprocal tax treatment. This would disregard, without justification, the long established and internationally accepted standard for identifying the nationality of a vessel -- its country of documentation, the flag of the vessel. Looking beyond the flag to determine beneficial ownership in a ship-owning corporation is a nightmarish prospect because of the ownership structures and mechanisms prevalent in international shipping.

Multinational ownership or transnational cooperative ownership of vessels and shipping companies is frequent. Cross-border ownership in consortia and other joint ventures are increasingly common.[2] Indeed, the European Community is developing a system for a "European corporation" which will disregard national boundaries. Entry of such corporations into the international shipping business would play havoc with the tax scheme contemplated by H.R. 3838.

Furthermore, a ship may be documented on behalf of its bearboat charterer, instead of its owner, so that ownership of the ship could be irrelevant for jurisdictional purposes.3/ Looking to the owner in order to tax the vessel's revenue would therefore ignore the real income recipient.

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[2] The administrative task of determining the appropriate nationality of the vessel owner would be severely tested (or frustrated) by the not-so-hypothetical example of a Liberian-flag tanker owned by a Liberian corporation, which, in turn, is owned by a Luxembourg or Swiss holding company, the shares of which are owned by corporate entities in five European nations and the Bahamas. Ironically, in most cases, whether Liberia is the basis of the test (via the current flag test) or whether any one of the entities set forth in the not-so-hypothetical scenario described above is the basis (under the proposed test), the result would be the same. . . no taxation due to reciprocity since the owners would be nationals of countries providing tax reciprocity by national law or treaty with the United States.

A vessel's flag, as already noted, has long provided the sole standard for determining jurisdiction and responsibility with respect to the vessel. The proposed revision of Sections 872 and 883 would deny the sound bases upon which flag jurisdiction is founded, and would reverse previous Congressional findings supporting continued resort only to the vessel's flag for determining the vessel's (and its owners') responsibilities.4/ In enacting the Ocean Shipping Act of 1978, Congress, after much debate, defined a "controlled [ocean] carrier" for purposes of legislation designed to strictly regulate the economic activities of certain state-owned ocean common carriers whose conduct destabilized ocean liner shipping.

3/ A bareboat charter is a contract for lease of a ship for a specified time period and giving the lessee complete possession and control of the ship for the lease's duration.

4/ It is worth noting that earlier this month the United States signed an international convention (treaty) which states: "Ships have the nationality of the State whose flag they are entitled to fly." (United Nations Convention on Conditions for Registration of Ships, Article 4.2, U.N. Doc. TD/RS/CONF/L. 19.) Although U.S. signing of the convention does not make it U.S. law (the required ratification procedure must be followed), the U.S. has (by signing) indicated its acknowledgement of the international legal principles governing jurisdiction over vessels. Looking beyond the flag country for purposes of asserting jurisdiction over activities of the ship is contrary to settled international law.

Control was defined in terms of vessel flag: ownership or control of carrier assets "by the government under whose registry the vessels of the carrier operate." (46 U.S.C. app. §1702(8)). At first, that defining phrase was opposed, and the Senate version of the original bill (S. 2873, 95th Cong.) did not include it. It was believed that a government which controlled a shipping line could document its vessels in another country, thus avoiding the new law's restrictions. The vessel flag test was nevertheless included because to have done otherwise would have violated the international principle establishing the country of vessel documentation as the factor determining a vessel's legal status.[5] This lesson, as articulated in the Senate Report, is even more meaningful today, as we prepare for greater international cooperation and stability in international markets.[6] Such stability, much needed and desired by providers and users of shipping services for purposes of business planning, is greatly enhanced by the vessel flag test which establishes a clarity of nexus between the vessel and the source of its legal status and responsibility.

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[5] Sen. R. No. 95-1260 (95th Cong. 2d Sess., September 29, 1978), at 30.

[6] Agreeing with the arguments of the Executive Branch, the Senate Report on the bill which became the Ocean Shipping Act of 1978 said:

> Under international law, it is the state of a vessel's registry, and not the nationality of the actual owners, which determines the legal status of a vessel. Accordingly, the U.S. Government and all governments employ the country of registration and not of actual ownership in the application of national and most-favored-nation treatment under bilateral treaty commitments, as well as in the application of provisions of multinational agreements and conventions. Legislation which looked behind the flag of a vessel to determine its nationality or ownership would thus be inconsistent with general

(footnote continued)

Moreover, any change in the vessel flag test would undermine longstanding U.S. policy supporting flag state responsibility in important international conventions administered by the International Maritime Organization of the United Nations (IMO,

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> international practice and with the U.S. Treaties of Friendship, Commerce and Navigation. Without the inclusion of the registry phrase, this legislation would in effect inform certain treaty partners that the U.S. does not recognize the sovereignty of their flags and would treat certain of their vessels differently from others. Should a state-owned carrier register its vessels under the flag of a country with which we have such a treaty, any effort to enforce this legislation with respect to those vessels would, of course, be a violation of that treaty.
>
> Furthermore, were the definition to omit the registry phrase, it could create serious practical difficulties. The complex and frequently multinational corporate structures of many shipping enterprises today sometimes render it almost impossible to identify fully the nationality of a ship's owners. Even a vessel wholly or largely owned by a state enterprise would, if registered under a foreign flag, almost certainly be hidden behind one or more corporate veils. Hence, legislation which attempted to define the nationality of vessels in terms other than their flags could not only set an unfortuante precedent, but could also greatly complicate maritime relations. Moreover, by providing a procedure whereby operations of a potential competitor might be significantly impeded by a mere accusation of state ownership, a definition which omitted the registry limitation, could subvert the intention of this legislation.

Id.

formerly IMCO), all of which rely upon the vessel flag test.[7/]

The foregoing principles alone make the case against the proposed revision of the reciprocal exemption rules. In addition, however, is the administrative burden which the revision would entail. Tax liability, particularly for a single corporation owning more than one ship, would have to be

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[7/] They are as follows:

1. The International Convention for the Safety of Life at Sea (SOLAS), 1960 and 1974.

2. International Regulations for the Prevention of Collision at Sea (COLREGS), 1960 and 1972.

3. International Convention on Loadlines, 1966.

4. International Convention on Tonnage Measurement of Ships, 1969.

5. Convention on the Prevention of Marine Pollution by Dumping of Waste and Other Matter, 1972.

6. International Convention for the Prevention of Pollution of the Sea by Oil, 1954, as amended.

7. International Convention for the Prevention of Pollution from Ships, 1973.

8. International Convention Relating to Intervention on the High Seas in Cases of Oil Pollution Casualties, 1969 (Intervention Convention).

9. International Convention on Civil Liability for Oil Pollution Damage, 1969.

10. International Convention on the Establishment of an International Fund for Compensation for Oil Pollution Damage, 1971.

11. Convention Relating to Civil Liability in the Field of Maritime Carriage of Nuclear Materials, 1971.

determined case-by-case, vessel-by-vessel, voyage-by-voyage. The necessary expenditure of administrative costs in determining residence, ownership and tax liability would be excessively burdensome not only to the U.S. Government but to the taxpayers sought to be assessed. Altered trading patterns, vessel transfers, and changes in ownership would increase the administrative difficulties. Furthermore, the Internal Revenue Service will have to find and analyze foreign internal laws to determine whether there is reciprocity of treatment of U.S. ship owners, but will be unable to do so. The Service has not been able to accomplish this in the past, lacking the necessary resources. Enactment of the proposed revision of Sections 872 and 883 will therefore impose a burden on the Service which it cannot fulfill.

Since the apparent objective of the proposed change in reciprocal exemption rules is to induce a few non-reciprocating countries to amend their practices, the ultimate result will be little, if any, increase in tax revenues.[8/] The tonnage of vessels registered under the flag of non-reciprocating countries is only a minor percentage of total world vessel tonnage. Not

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[8/] It may be noted that some countries are landlocked, and have had no reason to adopt laws taxing income of foreign ship owners. However, if shipping company shareholders would have to be located under the provisions of H.R. 3838, such countries would need to accommodate their laws, possibly adopting some type of retaliatory tax which has nothing to do with ocean shipping. The confusion which would be created for shipping companies will thus be unending.

all of those vessels would necessarily call at U.S. ports, further reducing both the potential beneficial consequences of the proposed tax change and the adverse results of leaving the reciprocal exemption rules unchanged. Thus since the number of vessels thereby involved, and the attendant revenue, do not constitute a substantial portion of world-wide shipping revenues, the tax benefits to the U.S. will be small. There is, furthermore, no assurance that the scheme will work to convince the uncooperative countries who may see a net revenue benefit in the greater number of foreign vessels for them to tax.

B. Income Sourcing Rules

Under current U.S. tax law shipping income which is treated as U.S. source income (in the context of international shipping) is only a small percentage of income derived from shipping in U.S. foreign commerce. A taxpayer's U.S. source income is a percentage of total shipping income in proportion to the costs and expenses incurred in the U.S. (that is, within the 3-mile limit of territorial waters). That formula determines gross income which can be reduced by costs and expenses associated with the U.S. source income, producing net income subject to U.S. taxation. The result is that U.S. taxation reaches a small portion of shipping income produced by foreign vessels in U.S. commerce.

Apparently to reach a greater portion of such income, H.R. 3838 (Section 613(a)) proposes two changes. One would treat 50 percent of total shipping income as U.S. source income. The other would impose a 4 percent tax on gross shipping U.S. source income. The 50 percent rule would apply to income derived from voyages beginning or ending in the U.S.

A fundamental defect in the 4 percent tax on gross income is that it would be discriminatory. Often there is no net income, considering for example that depreciation is a deductible item; and since U.S. companies are not taxed in the manner proposed by H.R. 3838, foreign ship owners would be subject to taxation in a way that is not applied to any U.S. business. Such treatment of foreign ship owners wold violate a fundamental principle of U.S. tax policy: that taxes on gross income are to be avoided when they do not produce an approximation of tax on net income. In fact, it is to avoid such unfair taxation that the U.S. has tax treaties with other countries. Thus, the 4 percent gross tax provision of H.R. 3838, by treating foreign ship owners differently and in a more burdensome way than U.S. owners, could violate U.S. treaties of friendship, commerce and navigation.

As already explained, one of the more harmful aspects of H.R. 3838, in the shipping area, is that the drastic changes being proposed will subject the U.S. to retaliation by other countries which will adopt comparable tax provisions. The adverse consequences are apparent. Vessels do not confine their trading to routes involving their home country (however defined). Rather, cross-trading is more common, whereby vessels serve trade routes not including the home country. Therefore, the outer limits of possible taxation based on the example which would be established by H.R. 3838 would be endless. If all states emulated the U.S., by adopting a 50 percent sourcing rule, each would make similar tax claims for the same voyage (involving multiple port calls) producing in excess of 100 percent source income upon which taxation would apply. Thus, vessel owners not directly affected by the proposed changes would be indirectly affected by the domino effect produced by the retaliatory action of other countries.

As in the case of proposed changes in the reciprocal exemption rules, the new sourcing rules as provided in H.R. 3838 apparently are aimed at countries which do not provide reciprocal tax treatment. In this instance the objective appears to be to induce revision of foreign tax laws which already tax gross shipping income.

It is not safe to assume, however, that this objective can be achieved. The countries which impose such a gross tax reportedly are few (apparently including India, Pakistan, Bangladesh and Singapore), and their vessels represent a very small percentage of participation in U.S. foreign commerce. These countries may therefore gain a net benefit by taxing the gross income of other countries' ships.

Also, the contribution which these few countries' vessels would make to U.S. tax revenues under the H.R. 3838 proposals is likely to be small in comparison to the administrative burden of finding the actual income recipients and assessing the tax. Implementation of the proposed sourcing and gross tax provisions would require ascertainment of the corporate history and ownership residence for the thousands of foreign vessels calling each year at U.S. ports. This would have to be done for each ship on every voyage, since the registry, charter or ownership could change.

The sourcing rules, and the attendant tax withholding provisions, are, in fact, totally unworkable. It is to be required that the tax on gross income would be withheld by the payor or withholding agent. If the tax is not collected, the payor would be personally liable, making him insecure in his ability to collect the necessary amount for withholding. The withholding agent will therefore demand proof of the foreign ship owning taxpayer's entitlement (by reciprocal exemption or treaty) to net tax treatment before the withholding agent will agree not to withhold against the gross tax. However, no mechanism exists to provide such information to the withholding agent. With the possible exception of treaties or other international agreements, no resource is available by which one can ascertain who is entitled to net tax treatment. The Internal Revenue Service has not been able to provide such information. Accordingly, the free flow of ocean commerce will be halted by the unwillingness of foreign shipowners and their customers to assume the risks inherent in the H.R. 3838 proposals.

In addition, withholding agents will have the burden of determining the foreign ship's ownership, and that will prove impossible with respect to foreign corporate owners, since the identity of foreign shareholders will not be ascertainable. Disclosure of such corporate shareholders can violate the principle of corporate anonymity, and therefore can never be required. A similar effort to reach the shareholder owners of foreign companies was attempted under the Foreign Investment in Real Property Tax Act of 1980, but the attempt was abandoned by the U.S. when it proved to be totally unworkable, and the disclosure requirement became impossible to enforce. The result will be the same under H.R. 3838.

The proposed 4 percent tax on gross shipping income is, in addition, apparently based upon the mistaken impression that, there are great profits which the current tax on net income allows to escape U.S. taxation. However, where shipping profit margins are often typically narrow, a tax which disallows deductions permitted to other industries would drive shipping companies from U.S. markets. This would reduce competition and allow rate escalations depriving U.S. exporters of competitive prices for their goods sold abroad and burdening U.S. consumers with higher prices as the increased costs of shipping sans competition inevitably leads to higher rates. Hence, the ultimate prejudice would be to U.S. consumers of imported goods, and U.S. users of shipping services. An alternative to some foreign vessel owners would be to shift their trading patterns and serve U.S. customers via the ports of Canada and Mexico, completely avoiding the new taxing mechanisms.

C. Subpart F, and Capital Construction Fund

The proposed changes regarding Subpart F and the Capital Construction Fund are of concern primarily to INTERTANKO's U.S. members. However, as a whole, INTERTANKO opposes measures which detract from the stabilization of its shipping services by creating a disequilibrium among INTERTANKO's members.

Current law provides that earnings of foreign-flag shipping companies controlled by Americans have tax-deferred treatment if the earnings are reinvested in shipping operations. The tax deferral would be repealed by H.R. 3838 (Section 621(c)), and as a result U.S. investment in such foreign-flag shipping would be with after-tax dollars, whereas foreign-controlled shipping reinvestment can be made with pre-tax or untaxed earnings. U.S.-controlled foreign shipping services would therefore be prejudiced directly at home, as well as indirectly abroad by the inevitable retaliatory taxing actions of other countries discussed above.

Section 233 of H.R. 3838 would impose new limitations on use of a Capital Construction Fund established by U.S. companies. These limitations will further undermine U.S. carriers' competitive posture and should be reconsidered.

III. CONCLUSION

As the foregoing discussion shows, maritime related provisions of H.R. 3838 are not revenue measures, since they are very unlikely to produce any tax collections. Rather, those provisions are designed to force changes in the national taxation practices of certain foreign countries. As such the provisions seek unworkable objectives (discussed above) which would, if enacted, create chaotic conditions in international ocean commerce.

Under H.R. 3838, the standards by which ocean transportation is governed in the commercial and judicial spheres may not be relevant to taxation, and the jurisdictional basis upon which all maritime activities are founded (locus of documentation) would be disregarded in the vital area of taxation. INTERTANKO believes that such a view is founded on an absence of understanding of the unique nature of ocean shipping, and of the instability and commercial disharmony which would be caused by failing to adhere to the vessel flag test.

Unlike the capital structure of other "foreign" businesses, ships move from country to country. As already discussed, international ocean shipping is a singular enterprise. It is a service industry, but one which does not cater only to a specific or narrow sector of the consuming public. Rather, ocean shipping is the means by which almost all international trade is accomplished. Accordingly, any dichotomy in treatment of ocean shipping will ultimately lead to confusion, anti-competitive reactions, and wasteful, increased costs.

Common practice among trading nations is therefore very important. If the United States signals a departure from the current widespread reciprocal treatment currently being fostered, solely to bring some recalcitrant states into the fold, the present felicitous conditions will inevitably be severely disrupted by the retaliation perceived as necessary by other countries. The need to avoid such consequences was recently recognized by the U.S. Congress in enacting the Shipping Act of 1984 (46 U.S.C. app. §§1701 _et seq._) In the Act's declaration of policy, stating the Act's purposes it is said that one purpose is:

> to provide an efficient and economic transportation system in the ocean commerce of the United States that is, insofar as possible, in harmony with, and responsive to, international shipping practices....

46 U.S.C. app. §2(2).

Since there is no demonstrated need for, or significant benefit from, the tax changes proposed in H.R. 3838, their rejection would enable the U.S. to continue to promote an

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efficient and economic ocean transportation system in U.S. commerce and world wide. U.S. shipping companies are increasingly providing service to the international community, not just to U.S. importers and exporters; and it is therefore vital for the United States to encourage and promote harmony of international practices that are consistent with long-established and well functioning international principles. Thus, for the U.S. to abruptly overthrow the reciprocal exemption rules, based on the vessel flag test, is unwarranted. Accordingly, INTERTANKO urges that the proposed changes in H.R. 3838, discussed above, should not be adopted.

February 18, 1986

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STATEMENT OF THE
INVESTMENT COMPANY INSTITUTE

The Investment Company Institute* (the "Institute") respectfully submits the following comments on those provisions of H.R. 3838, the "Tax Reform Act of 1985," which directly affect mutual funds, unit investment trusts and their shareholders. Mutual funds are open-end investment companies registered under the Investment Company Act of 1940. Mutual funds are typically taxed as regulated investment companies under Subchapter M of the Internal Revenue Code. Unit investment trusts are also registered investment companies. Although some unit trusts qualify under Subchapter M of the Code, most are treated as grantor trusts for federal income tax purposes.

1. IRA Offset [Section 1101]

Under the pension provisions of H.R. 3838 an individual's IRA contribution limit would be reduced, dollar for dollar, by elective contributions to either a 401(k) plan or a 403(b) program.

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* The Investment Company Institute is the national association of the American mutual fund industry. Its membership includes 1,455 open-end investment companies ("mutual funds"), their investment advisers and underwriters. Its mutual fund members have assets of about $440 billion, accounting for approximately 90% of total industry assets, and have over 20 million shareholders. The Institute also represents the unit investment trust industry.

As stated in previous testimony before this Committee,** the Institute opposes this linkage between IRAs and other retirement programs as an indirect attack on IRAs, which is inconsistent with our national retirement policy. This linkage is neither logical nor justified. The IRA was expanded by Congress as recently as 1981 for the specific purpose of supplementing retirement savings accumulated in employer-sponsored plans. Furthermore, IRAs have not only made a significant contribution to retirement savings (currently nearly $200 billion), but they have created considerable new savings as well ($18 billion in 1984, and probably $50 billion by 1990). In addition, IRAs have made a significant contribution to retirement savings. The IRA is a unique, simple and effective retirement savings vehicle, which permits individuals to exercise their freedom of investment choice through a variety of financial institutions offering a broad selection of investment products. Rather than limiting IRA contributions, the IRA should be expanded by increasing the spousal IRA limit from $2,250 to $4,000.

** See testimony of the Investment Company Institute before the Subcommittee on Savings, Pensions and Investment Policy, Senate Finance Committee, dated January 28, 1986, and Institute testimony before the Senate Finance Committee, dated July 11, 1985.

2. Stock Redemption Expenses [Section 314]

H.R. 3838 provides that a corporation may not deduct expenses incurred in connection with the redemption of its stock. Instead, such expenses are to be treated as capital items. Examples of non-deductible redemption expenses include expenses incurred in connection with a corporation's repurchase of its stock, such as amounts paid to repurchase stock, premiums paid for the stock and legal, accounting, brokerage, transfer agent and similar fees. On its face, the language of the bill would apply to all corporate redemptions, including those of a mutual fund, i.e., an open-end management investment company typically taxed under Subchapter M of the Internal Revenue Code.

The Institute requests an exception from this rule denying the deductibility of redemption expenses for expenses incurred in connection with the redemption of mutual fund shares in the ordinary course of business. On the basis of the Committee Report language accompanying this provision, it appears that the provision was adopted in response to a concern regarding the treatment of redemption expenses incurred to prevent a hostile takeover, i.e., so-called "greenmail" situations. Although generally subject to the Subchapter C rules relating to all corporate redemptions, a mutual fund's redemption of its shares may be clearly distinguished from other corporate redemptions. Mutual funds are required by law (the Investment Company Act of 1940) to redeem their shares upon the demand of the shareholders.

Mutual funds are constantly issuing and redeeming shares as part of their normal day-to-day functions.

This constant process of issuing and redeeming shares, which distinguishes a mutual fund from other corporations, was recognized by the IRS in Rev. Rul. 73-463, 1973-2 C.B. 34. That ruling provides that in the case of a mutual fund, unlike other corporate taxpayers, its stock issuance expenses (other than those incurred in an initial 90 day offering period) are deductible as ordinary and necessary business expenses. For purposes of this ruling, the IRS included mutual fund redemption expenses as deductible expenses relating to stock issuance. Thus the ruling cites processing applications for redemption, processing stock certificates, maintaining stockholder share accounts and costs of issuing checks for the proceeds of redeemed shares as specific examples of deductible stock issuance expenses.* In concluding that these types of expenses are deductible, the ruling notes that the

> "unique circumstances which permit shareholders of an open-end investment company to withdraw their capital from the

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* The IRS also recognized that mutual fund redemption expenses are deductible under section 162 in GCM 34609 and in Technical Advice Memorandum 7112151030A.

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> company on demand leads to the conclusion that continuous capital raising efforts by the company after the initial stock offering period is an essential part of its day to day business operations."

The Institute believes that this provision of H.R. 3838 was not intended to alter the present law treatment of mutual fund redemption expenses and that there is no sound policy reason for doing so. Accordingly, we believe that the denial of deductibility for corporate redemption expenses which is set forth under section 314 of H.R. 3838 should specifically exclude expenses incurred in connection with a mutual fund's redemption of its stock in the ordinary course of business.

3. Commercial Annuity Bias [Section 1123]

The pension provisions of H.R. 3838 impose, in section 1123 of the bill, a uniform 15 percent withdrawal penalty on all distributions from tax-favored retirement programs prior to a participant's attainment of age 59 1/2, death or disability. (Tax-favored retirement programs include IRAs, 403(b) programs and all qualified plans.) However, in a significant departure from past policy, an exception from this uniform 15 percent early withdrawal penalty is provided for any distribution which is part of a series of substantially equal periodic payments (not less frequently than annually) over the life of the participant or the joint lives of the participant and a beneficiary. The Committee Report to the bill expressly notes that, in the case of a defined contribution plan or IRA, the Committee intends this exception from the penalty tax to be available "only if the plan or IRA purchases a commercial annuity to fund the individual's benefit."

This language in the Committee Report to H.R. 3838, if not changed in the Senate Finance Committee Report, would represent a startling and unjustified anti-competitive intrusion into the financial marketplace. Under the Ways and Means Committee Report, IRAs and defined contribution plans funded through mutual funds, unit trusts or depository institutions, such as banks, savings and loans, and credit unions could not satisfy the requirements for the exception from the early withdrawal penalty. For a participant's benefit schedule to qualify for this exception, his retirement assets would have to be withdrawn from the mutual fund, unit trust, bank, savings and loan or credit union and used for the purchase of a commercial annuity contract. The plan participant would be denied the opportunity to fund his retirement program through his preferred investment medium, and Congress would have clearly slanted the retirement plan market in favor of the life insurance industry.

This commercial annuity bias of the Ways and Means Committee Report on H.R. 3838 takes on added significance when it is noted that there is no exception from the early withdrawal penalty for distributions from a qualified plan on account of separation from service. Thus, it is not only an employee's seeking to withdraw retirement plan assets for temporary cash needs (e.g., hardship withdrawals from a profit-sharing plan) which would trigger the application of the withdrawal penalty, but also withdrawals on account of separation from service. An employee who separates from service under his employer's defined contribution plan prior to attaining age 59 1/2 will be subject to a 15 percent penalty upon the distribution of this benefit in any form other than a commercial annuity.

Because this express preference for commercial annuity contracts will increase the cost of retirement benefits in an anti-competitive manner, the Institute urges that the commercial annuity bias in H.R. 3838 be eliminated. The policy goal achieved by the commercial annuity requirement, the maintenance of a steady, fixed retirement income stream, may also be accomplished through alternative means. For example, the proceeds of the participant's account could be placed in an irrevocable trust under which the beneficiary could vary the investment medium, but not the benefit payment stream.

Similarly, the exception from the 15 percent withdrawal penalty could be defined as including substantially equal periodic payments based on life expectancy from a defined contribution plan or IRA, regardless of the investment medium, with a provision for the imposition of the withdrawal penalty in the event of a subsequent violation of the restrictions. If the Committee is concerned that the payment stream could be broken by either a deviation in the payment schedule or an increase or a decrease in the payment amount, the withdrawal penalty could be imposed to prevent abuse of the periodic payment exception to the early withdrawal penalty.

Thus, for example, the bill could provide for the imposition of the 15 percent early withdrawal penalty in the event of any increase or decrease in the required payment amount because of factors other than investment earnings or losses or recomputed life expectancy. This proposal could be drafted in one of two alternative structures. First, the 15 percent penalty tax could be imposed upon the lesser of the amount paid out prior to the participant's attaining age 59 1/2, death or disability or the amount remaining in the participant's account at the beginning of the year in which the deviation from the scheduled payments occurs. Alternatively, in the event of a deviation from the scheduled payments, a 15 percent penalty tax could simply be imposed on all amounts withdrawn from the account prior to attaining age 59 1/2, death or disability.

Enforcement of this proposal would not be dependent on random IRS audit. Any deviations from the scheduled income stream could be reported to the IRS on the 1099-R or W-2P Forms, which currently are used to report pension distributions. Once an account maintained by a financial institution was coded for restricted periodic payments, deviations from the prescribed income stream, other than deviations based on investment return and annual re-computation of life expectancy, would trigger a report to the IRS. Rollovers, but not trustee to trustee transfers accompanied by appropriate restrictive instructions, could also be prohibited to ease enforcement of the prescribed, penalty-free periodic payment stream.

The Institute believes that these proposals and others which could be readily devised would accomplish the policy goal of permitting an exception from the early withdrawal penalty in the case of substantially equal periodic payments based on life expectancy. Moreover, enforcement of the limited exception from the 15 percent early withdrawal penalty may be achieved without relying on random IRS audit procedures, self-policing through the 1040 return or the potentially costly "lock-in" effect of a commercial annuity contract. However, unlike the provisions of H.R. 3838, the proposals described above would not unfairly restrict a participant's freedom of investment choice for funding retirement benefits.

4. Effective Dates of the Tax-Exempt Financing Provisions of H.R. 3838 [Title VII]

In February 6 letters to Chairman Packwood and Senator Long, the Institute requested that the Committee give consideration to an early announcement that the January 1, 1986 effective date contained in H.R. 3838 with respect to obligations issued by state and local governments will be changed to January 1, 1987. After further study of the problems currently faced by mutual funds and unit investment trusts investing in state and local government obligations, we again emphasize the urgent need for delay in the effective date of these provisions until January 1, 1987 or, if the bill is not enacted until after July 1, 1986, at least six months following the date of enactment. This delay is necessary to permit issuers, underwriters, bond counsel and purchasers an opportunity to study the legislation and develop appropriate procedures to insure compliance with the new requirements of the law.

Absent a delayed effective date, we anticipate substantial disruption of the tax-exempt bond markets, with price and yield differentials developing between those obligations issued before the effective date of the new provisions and those issued after that date. It is our understanding that these differentials are already beginning to emerge as certain issuers are forced to pay somewhat higher rates to market post-December 31, 1985 obligations, which may be subject to the uncertain requirements of the proposed legislation.

Moreover, we believe that regulations or other interpretive guidance may be necessary with respect to certain provisions in H.R. 3838 to permit issuers to issue and buyers to purchase obligations with an explicit understanding of the intended status of a particular state or local obligation. To the extent that the stability of the municipal bond marketplace is based in part upon assurances of compliance with applicable law by issuers and bond counsel, a period of time sufficient for the study of applicable law and the development of uniform covenants and warranties appears to be essential.

For these reasons, the Institute again urges a delay in the effective date of the tax-exempt financing provisions of H.R. 3838 sufficient to give the municipal bond marketplace time to adjust to the new rules and standards of the bill.

5. Interest on Non-Essential Function Bonds Held By a Tax-Exempt Mutual Fund [Section 59]

H.R. 3838 provides that the tax-exempt interest paid on certain nongovernmental obligations, i.e., nonessential function bonds, will be treated as a preference item for purposes of the alternative minimum tax applicable to both individuals and corporations. Code section 852(b)(5) permits qualifying mutual funds to distribute exempt-interest dividends to its shareholders. However, H.R. 3838 does not specifically provide that nonessential function bond interest which "flows through" a qualifying mutual fund to its shareholders in the form of exempt-interest dividends will retain its character as a preference item in the hands of their shareholders. The bill simply provides that, under new Code section 59(d)(3), the Secretary of the Treasury may allocate alternative minimum tax preference items between a regulated investment company (RIC) and its shareholders.

We believe that the regulatory authority conferred by the Committee Report to H.R. 3838 should be clarified so as to provide guidance to mutual funds distributing interest on nonessential function bonds to their shareholders prior to the issuance of Treasury regulations. Such clarification should provide that the current law treatment of Code section 58(f) will be retained regarding the allocation of a RIC's capital gain dividends and other preference items other than interest on non-essential function bonds. With regard to interest on nonessential function bonds, it should be clarified that the Committee intends the regulations to provide that the RIC allocate non-essential function bond interest to its shareholders in the same proportion that the exempt-interest dividends paid to each shareholder bear to the tax-exempt interest income of the RIC, with expenses allocated on a pro rata basis between non-essential function bond interest and the other taxable and tax-exempt income of the RIC.

6. Proposed Repeal of the 80-20 Rule [Section 612]

The foreign tax provisions of H.R. 3838 would, in section 612 of the bill, repeal the so-called "80-20" rule of current law which permits shareholders of a U.S. corporation, including a RIC, to treat all of dividends received from the corporation as foreign-source income, if less than 20 percent of the corporation's gross income is derived from U.S. sources. If the 80-20 rule is repealed, shareholders of U.S. corporations, including RICs, would be required to treat all dividends as U.S. source income, even if the income of the RIC is entirely derived from foreign sources.

The proposed repeal of the 80-20 rule is particularly significant for those RICs which have foreign shareholders. These shareholders would be subject to 30 percent nonresident alien withholding (or a lesser treaty rate, if applicable) on all dividends paid to them by the RIC which are treated as U.S. source income. This is so, even if the RIC income is in fact wholly derived from foreign sources, as for example, in the case of a RIC which invests solely in foreign securities.

It should be noted that although the repeal of the 80-20 rule would be very significant to the foreign shareholders of a U.S. RIC, it is of little significance for a RIC's U.S. shareholders. This is because RICs may elect to "flow-through" their foreign-source income and the associated foreign taxes paid by the RIC to their U.S. shareholders under Code section 853, without regard to whether the RIC satisfies the 80-20 rule. If a RIC qualifies to make the election under Code section 853, its U.S. shareholders may treat a proportionate share of their dividends as foreign source income for purposes of the foreign tax credit and may treat themselves as having paid the associated foreign tax.

The election under Code section 853 affects the sourcing of a RIC's dividend only for purposes of the foreign tax credit; it does not have any effect on the sourcing of dividends for purposes of the 30 percent withholding requirement on dividends paid to foreign shareholders.

Therefore, with the repeal of the 80-20 rule, U.S. shareholders of a RIC, but not foreign shareholders of the same RIC, may, under section 853, treat a proportionate share of their dividends received as foreign source income. This distinction between the U.S. and foreign shareholders of a RIC appears to be unintentional. The policy reasons for allowing a flow-through of foreign source income to U.S. shareholders of a RIC for purposes of the foreign tax credit apply equally in the case of foreign shareholders of a RIC. Accordingly, the Institute urges an expansion of the flow-through treatment provided under section 853 to include foreign shareholders. Under this proposal, foreign shareholders could treat a proportionate share of the dividends received by them from a RIC invested in foreign securities as foreign source income (just as U.S. shareholders do under current law for purposes of the foreign tax credit). The withholding tax would then apply only to that portion of the foreign shareholder's dividend which represents income derived by the RIC from U.S. sources.

The Institute believes that this proposal is entirely consistent with the conduit principles which govern the federal tax treatment of RICs and their shareholders. That is, foreign shareholders of the RIC would be treated as if they owned directly interests in the foreign and U.S. securities held by the RIC. In addition, this change would eliminate the unwarranted distinction which currently exists between U.S. and foreign shareholders of a RIC under Code section 853.

7. Passive Foreign Investment Companies [Section 625]

Under current law, a U.S. shareholder in a foreign investment company may not receive capital gains treatment upon redemption or sale of his shares in the investment company to the extent of the investor's share of the foreign investment company's accumulated earnings and profits. However, this provision is generally not applicable if less than 50 percent of the foreign investment company's stock is held directly or indirectly by U.S. persons.

H.R. 3838 would eliminate the 50 percent threshold under current law and thus require recognition of ordinary income, rather than capital gain treatment, for any U.S. shareholder disposing of stock in a foreign investment company. In addition, a U.S. investor in a passive foreign investment company would be required to recognize as current income a portion of the passive foreign investment company's investment earnings, regardless of whether such earnings have been actually distributed to the shareholder investor.

These new proposals relating to the taxation of U.S. shareholders in foreign investment companies exacerbate current tax law problems for U.S. mutual funds investing abroad and create additional new problems for those funds. These problems stem primarily from the new recognition of income requirements and the definition of both a foreign investment company and a passive foreign investment company under H.R. 3838.

Subchapter M requires that a RIC distribute to its shareholders at least 90 percent of its net income. Therefore, a requirement that a RIC recognize and distribute to its shareholders income which it has not yet received creates an awkward book/tax disparity for a RIC. Although the bill permits a deferral of the otherwise current recognition of income earned by the passive foreign investment company in the case of a U.S. shareholder who agrees to pay taxes on the amount deemed received as well as interest on the deferred tax, this procedure appears to be quite complex for a RIC.

This problem may be particularly severe for those RICs which invest a portion of their portfolios in countries, such as Taiwan and Korea, which prohibit direct investment by foreigners. It is our understanding that U.S. RICs wishing to invest in Korean or Taiwanese securities may do so only by investing in a pool of securities established for this purpose. Such a pool of foreign securities would, presumably, fall within the definition of a passive foreign investment company under H.R. 3838. The net effect of the proposal to tax U.S. shareholders currently on the income earned by passive foreign investment companies appears to be a significant disincentive against investing in the securities of those countries which have, for whatever reason, attempted to restrict direct foreign investment in their securities.

A second problem arising for a U.S. RIC investing in foreign securities relates to the definitions of both a foreign investment company and a passive foreign investment company under H.R. 3838. Although this problem exists under the current law definition of a foreign investment company in Code section 1246(b), the proposal eliminating the 50 percent threshold in section 1246 and the current recognition of investment income requirement for investors in passive foreign investment companies significantly exacerbates the problem. Both terms rely upon a definition of a foreign investment company which may require a subjective judgment of whether a particular company is engaged primarily in the business of investing, reinvesting or trading in securities, commodities or interests thereon. Although this is a similar standard to that applied for registration as an investment company under section 3(a) of the Investment Company Act of 1940, it has been our experience that this standard is difficult to apply under U.S. law. Thus, notwithstanding the availability of substantial financial data on most U.S. corporations, it is not always definitely ascertainable that a particular holding company does not fall within the definition of a corporation engaged primarily in investing or trading in securities for purposes of the registration requirement of the Investment Company Act of 1940. Obviously, this judgment may be even more difficult to make in the context of a foreign holding corporation.

The definition of a passive foreign investment company under H.R. 3838 requires not only a judgment regarding a corporation's status as a foreign investment company, but also information regarding the percentage of the corporation's income received from passive sources or assets which are passive investments. It seems apparent that a minority U.S. shareholder may be unable to obtain this information from a foreign corporation which is not required by law to provide it.

Even assuming that a minority U.S. shareholder could obtain sufficient information to determine that a particular foreign corporation meets the definition of a passive foreign investment company, it may be unable to determine the amount of income which must be currently recognized. Significant questions exist as to whether a minority U.S. shareholder would have access to the information necessary to determine the amount of the deemed distribution to shareholders. By applying the rules applicable to controlled foreign corporations to corporations which are not controlled by U.S. persons, the bill appears to make numerous unjustifiable assumptions regarding a minority shareholder's access to financial statements of foreign corporations.

The Institute urges a reconsideration of these proposals as they would apply to mutual funds investing in foreign securities. A de minimis exception from these provisions for mutual funds that have less than 5 percent of their assets invested in foreign investment companies might provide some measure of relief, notwithstanding a RIC's inability to know with any certainty whether a particular investment is in fact an interest in a foreign investment company.

8. Technical Corrections to the Tax Reform Act of 1984 - Exempt-Interest Dividends from Regulated Investment Companies [Section 1504(c)]

Section 1504(c) of H.R. 3838 provides that a taxpayer who holds stock of a RIC for six months or less will be denied a loss on the sale of his shares to the extent of any exempt-interest dividends he has received from the RIC. The bill further provides that regulations of the Secretary of the Treasury may prescribe a shorter holding period (but not less than 31 days) to be applicable in those cases in which the RIC regularly distributes at least 90 percent of its net tax-exempt income.

The Institute urged a modification, essentially similar to that described above, to the six months holding period that was originally proposed in the Technical Corrections Act of 1985. However, the Committee Report language suggested by the Institute set forth in greater detail than is currently provided in the bill or accompanying Committee Report the standards by which a RIC could determine that its shareholders' holding period for loss recognition could be less than six months. Without this further explanation in the Committee Report, the Institute believes that all shareholders may, in effect, be subject to the six month holding period requirement pending guidance in Treasury regulations. Since Treasury regulations may not be issued for sometime, the Institute suggests the inclusion of Committee Report language, such as that which is attached hereto, to permit

RICs and their shareholders to reasonably determine when the standards for a shorter holding period have been met pending Treasury regulations.

* * *

The Institute appreciates the opportunity to present these comments on H.R. 3838 to the Committee. We would be glad to discuss these proposals in greater detail with the Committee staff.

IOWA STATE UNIVERSITY
OF SCIENCE AND TECHNOLOGY
Ames, Iowa 50011

OFFICE OF THE PRESIDENT

February 17, 1986

Members of the Senate Finance Committee
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Members of the Senate Finance Committee:

House File 3838, which is currently under consideration by the Senate Finance Committee, proposes taxation of the pension plan funds held by TIAA-CREF. More than 5,000 Iowa State University faculty and staff members currently participate in TIAA-CREF, the principal retirement program utilized by Iowa State University. The elimination of the long-standing tax exemption of TIAA-CREF would significantly reduce the benefits available to our faculty and staff members.

Because of the current condition of the Iowa economy, the state of Iowa has found it increasingly difficult to provide adequate salary and compensation increases to our faculty and staff members. A further reduction in the retirement and pension funds available to these staff members will have a detrimental effect on our ability to retain and attract the qualified staff needed to carry out the instruction, research and public service programs of Iowa State University.

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The proposal to tax pension plan funds held by TIAA-CREF would be inconsistent with the treatment provided other retirement and pension funds of business, industrial and charitable organizations. Our participants in this program would be severely penalized.

The objective of providing a portable, nationwide pension system for participants in higher education has been of immense benefit to the citizens of Iowa in enabling the university to attract highly qualified faculty and staff. The benefits paid by TIAA-CREF to its participants are taxed when retirement income is received. It does not appear that any special advantage would be given to its participants if the exemption from taxation of these pension plans is continued.

On behalf of the participants from Iowa State University, I urge your committee to continue the exemption from taxation of the pension plan funds held by TIAA-CREF.

Sincerely yours,

Robert Parks

W. Robert Parks
President

cc: Iowa Congressional Delegation

STATEMENT

ON BEHALF OF

ROBERT H. JEFFREY

SUBMITTED FOR THE RECORD
OF THE HEARINGS ON TAX REVISION

BEFORE THE

FINANCE COMMITTEE
OF THE UNITED STATES SENATE

HELD

JANUARY 29-30 AND

FEBRUARY 4-6, 1986

PREPARED BY

JONES, DAY, REAVIS & POGUE

The purpose of this testimony is to call your attention to a problem relating to personal holding companies ("PHCs") which has thus far received scant attention, but which can have a serious impact on individuals who choose to hold their investment assets in corporate form. The current 8 percent differential between corporate and personal capital gains rates, which would be increased to 14 percent by H.R. 3838, is inappropriate in the case of such investment assets, which are otherwise treated for federal income tax purposes as being held by individuals. As this testimony will discuss, the higher corporate capital gain rate serves as a disincentive to capital turnover, and thus hinders capital formation.

I. Historical Background

Many individuals have chosen to pool their income producing assets by placing them in a personal holding company. Among the legitimate, non-tax motivated reasons for such a choice of investment vehicle are:

1. The lessening of market risks through the pooling and diversification of assets;
2. The desire to diversify investment property so that annual income will be more predictable and steady;
3. The ease of dividing assets of a deceased investor among family members who might otherwise disagree about the division of inherited assets; and
4. The enhancement of management efficiency resulting from pooling of property.

Until the recent past, the top individual ordinary income tax rates were considerably higher than the corporate ordinary income tax rate. For example, in 1934, the corporate ordinary rate was 13-3/4 percent while the top individual marginal rate was 57 percent. Corporate rates gradually rose to 52 percent by 1952, declined to 48 percent in 1965, and declined again to 46 percent in 1979. Meanwhile, top individual marginal ordinary rates rose to over 90 percent in the fifties, declined to 70 percent in 1965, and stayed at that level until 1982, when they declined to 50 percent. Accordingly, until 1982, there was always a discrepancy of at least 20 percent between individual and corporate ordinary rates.

In addition to the non-tax advantages mentioned above, placing income producing assets in a corporation would have resulted in significant tax advantages (as long as little or no dividend was paid) since the income produced would have been taxed at a lower rate than if an individual or small group of individuals directly held the assets. To counteract this potential for tax avoidance, in 1934 Congress enacted a series of provisions known as the personal holding company ("PHC") rules. These rules essentially provide that in the case of a corporation controlled by five or fewer shareholders, and deriving at least 60 percent of its income from passive investments, undistributed income would be taxed at the higher individual rate. The rate at which such undistributed income was to be taxed has consistently tracked top individual marginal rates. For example, when the rate was cut to 50 percent in 1982, the PHC undistributed income tax rate was also reduced to 50 percent. Clearly, the purpose behind the PHC rules was to prevent individuals from receiving favorable tax treatment by placing their passive investment assets in corporate solution -- in other words, to put individuals who use a corporation as an investment vehicle on an equal footing with individuals who hold their investments directly.

The analysis has been quite different in the case of capital gains. In 1934, when the PHC provisions were first enacted, the top individual capital gains rate ranged from approximately 17 percent to 57 percent, depending upon how long the asset was held1/, while corporate capital gains were taxed at the ordinary corporate rate of 13-3/4 percent. This differential disappeared by 1943, and from 1943 until 1969, individual and corporate rates were taxed at an identical 25 percent level (with the exception of 1952-1954, when both were taxed at 26 percent). In 1970, individual capital gains

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1/ The 57 percent rate corresponded to the ordinary individual rate, and was applicable only to property held one year or less. The rate declined to approximately 46 percent for property held two years or less, 34 percent for property held between two and five years, 23 percent for property held between five and ten years, and 17 percent for property held over ten years.

rates became slightly higher than corporate rates (29 1/2 percent to 28 percent); this differential increased to 5 percent in 1972 (35 percent individual, 30 percent corporate) but by 1978 the two rates again were identical, set at 28 percent. Then, in 1982, for the first time in almost 40 years, individual capital gains rates dipped below corporate rates; they fell to 20 percent while corporate capital gains rates remained at 28 percent.* This differential would increase under H.R. 3838, which does away with any preferential rate for corporate capital gains (resulting in a rate of 36 percent, the ordinary corporate rate), while setting the individual capital gains rate at 22 percent. The various capital gains tax rates discussed herein are illustrated in graphic form by Exhibit A.

Given this historical background, it can be seen that there never was any meaningful potential to use PHCs for capital gains tax avoidance. Congress obviously did not find significant tax avoidance potential in the early (1934-1941) capital gains rate differential between individual and corporate taxpayers, since that difference never exceeded 10 percent, at least in the case of property held longer than five years. As noted above, even that slight difference disappeared in 1943, when the rates became identical. Similarly, no legislative action was taken in 1970, when individual capital gains rates once again exceeded corporate rates. Thus, it is clear that the PHC provisions are aimed at the potential corporate investments provide for ordinary income tax avoidance and that due to either identical or very similar capital gains rates, no such problem has ever been of concern in the capital gains area. Indeed, income from PHC capital gains is specifically allowed as a deduction under § 545(b)(5) from the undistributed PHC taxable income that is subject to the penalty tax.

II. Legislative Purpose

Given the above, it is clear that the underlying purpose of the PHC provisions is to place investors on an equal footing, whether they choose to hold their investment assets directly or in corporate form. But the contrary has now taken place. Since 1982, corporate capital gains have been taxed at a higher rate than individual capital gains. The rate discrepancy would be increased to 14 percent by H.R. 3838.

Given the underlying statutory purpose, it does not make sense to apply the higher corporate capital gain tax rate to assets sold by a personal holding company. Far from placing all investors on an equal footing, shareholders of a PHC would now be subjected to discriminatory treatment, without any policy reason for such a result. There is nothing inherently wrong with PHCs as investment vehicles, as long as they are not used as an abusive device to avoid tax at a higher individual tax rate. Indeed, the enduring existence of PHCs in the face of the special PHC tax provisions is eloquent testimony that they continue to serve the legitimate non-tax purposes discussed above. Taxing PHC capital gains at a higher rate than individual capital gains does not serve the underlying rationale for the PHC rules, since instead of returning PHC shareholders to a position of equality with individuals, shareholders are placed at a significant disadvantage.

This result is not only incompatible with the purpose underlying the PHC provisions; it is also antithetical to the entire thrust of the current tax reform effort, which has been to place similarly situated taxpayers on an level playing field. The recommended change of taxing capital gains of PHCs at the prevailing individual rate is perfectly compatible with the underlying purpose of the PHC rules, since those provisions were designed to place similarly situated individual investors in the same tax position, regardless of whether they held their investments directly or through a PHC. Conversely, the drive toward horizontal equity which underlies the tax reform effort would be totally incompatible with a provision that resulted in such similarly situated investors bearing widely disparate capital gains burdens, depending only on whether they happen to be investing directly or though a corporate vehicle. Therefore, to be consistent both with the current struggle for tax reform and the original motive behind the PHC rules, PHC capital gains should be taxed at individual and not corporate rates.

III. Economic Ramifications

The taxation of PHCs at corporate rather than individual capital gains rates is not only inconsistent with the original Congressional intent behind the PHC provisions, it is also contrary to the rationale advanced by the Ways and Means Committee for the higher corporate capital gains tax rate. The individual capital gains rate is designed as a relief provision, to ameliorate the heavy tax that would otherwise occur in the year of disposition; also, in recent years preferential capital gains treatment has served roughly to offset that portion of the sale proceeds attributable to inflation rather than true appreciation in value. Additionally, favorable capital gains treatment serves to encourage investment and thus capital formation.

Since, on the whole, operating corporations dispose of assets for business reasons, H.R. 3838 takes the position that the corresponding gains should also be treated as business income; therefore, that it is inappropriate to grant to corporations the same relief that is granted to individual taxpayers. Similarly, corporations will invest, and thus contribute to capital formation, on the basis of business necessity. Therefore, preferable capital gains treatment for the purpose of encouraging capital formation is not considered as necessary or even appropriate for corporations as in the case of individuals.

However convincing these arguments may be in the context of a corporation engaged in an active business, they are totally inapplicable in the case of a corporation used solely as a passive investment vehicle for a small group of individual investors. Merely to state those arguments demonstrates their lack of relevance in the PHC context.

Moreover, for the vast majority of corporations, capital gains constitute an insignificant portion of their overall tax liability. Most of their taxable income is derived from active business operations. A PHC, on the other hand, is by statutory definition largely a passive investment operation, where gains (and losses) typically occur with great frequency and often dwarf the ordinary income from dividends, interest, and the like.

Similarly, since a PHC is merely a pass-through operation, it cannot be compared even with those few active business corporations (such as insurance companies and financial institutions) which hold considerable amounts of investment assets as a source of security for their business operations. Such active corporations, upon seeing their return on equity reduced by the enactment of higher capital gains taxes, can increase premiums or other customer charges to make up the difference. The PHC, on the other hand, has no premiums or prices to increase because it has no product to sell. Thus, it has no way to recoup the increased capital gains tax.

Therefore, it will permanently lose investment capital. This, in turn, will lead to a decrease in investment turnover, and ultimately, a decrease in total tax revenues.

To illustrate the foregoing, assume a PHC which holds stock which yields 4 percent per year dividends and grows at a rate of 10 percent. If the PHC does not dispose of any capital assets during the year, its rate of return (without regard to ordinary corporate income tax) will be 14 percent, consisting of 10 percent unrealized gain in value plus 4 percent dividend income. Assuming a capital gain tax rate of 22 percent, its rate of return would be 11.8 percent if it sold all of its assets at the end of the year. If it sold half of its assets at the end of the year, its rate of return would be 12.9 percent. In other words, the rate of return is affected by turnover of assets. If the capital gains tax rate is increased to 36 percent, the effect increases dramatically. Using the same assumptions discussed above, the rate of return is 14 percent if there is no turnover, but only 10.4 percent if there is 100 percent turnover. Even at a 50 percent turnover rate, the rate of return would decrease to 12.2 percent.

In the real world, of course, the investor would not dispose of assets unless he felt that this action would have an overall positive effect on return which would outweigh transaction costs of selling the assets; that is, unless he felt the replacement assets would grow faster than the original assets. Accordingly, assume the previously postulated 10 percent growth rate in portfolio value increases by 0.1 percent for each 5 percent increase in turnover above 50 percent, and that it declines by 0.1 percent for every decrease in turnover below 50 percent; the effect of increased capital gains rates, as illustrated by Exhibit B, is dramatic. At a 22 percent capital gains rate, the rate of return only declines from 13 percent at zero turnover to approximately 12.6 percent at 100 percent turnover. Moreover, the rate of return is virtually unaffected as long as the turnover rate remains at 60 percent or less. Thus, at the 22 percent capital gains rate, investment decisions can be made on a tax-neutral basis.

Conversely, if the tax rate is increased to 36 percent, the rate of return will decrease from 13 percent at zero turnover to 11 percent at 100 percent turnover. Moreover, this effect begins to be felt almost immediately upon any turnover, resulting in a relatively much steeper curve than the 22 percent rate.

Obviously, such a significant effect will cause investors to decide to retain their capital assets due to tax considerations, even though it might otherwise be more advantageous to dispose of them. In other words, the rational investor will forego some of the presumed positive benefits of increased turnover to minimize the known negative effect of increased taxes. This means that investors will tend to retain long-held stock in mature companies and forego investing in growth stocks -- the possibility of future enhanced return will be outweighed by present higher taxes. This in turn will have a negative effect on capital formation, particularly in precisely those "high tech" companies which America must develop if it is to compete economically with the rest of the world. On the other hand, if turnover is not penalized, an investor would be more likely to take an investment risk on such stock. This illustrates that, for purposes of encouraging economic growth and capital formation, and also for purposes of allowing taxpayers to make investment decisions on a tax neutral basis, the proposed long-term capital gains rate of 22 percent is set at about the right level. Therefore, it stands to reason that PHCs, which act as individual investors, not operating corporations, should have their capital gains taxed at the same rate.

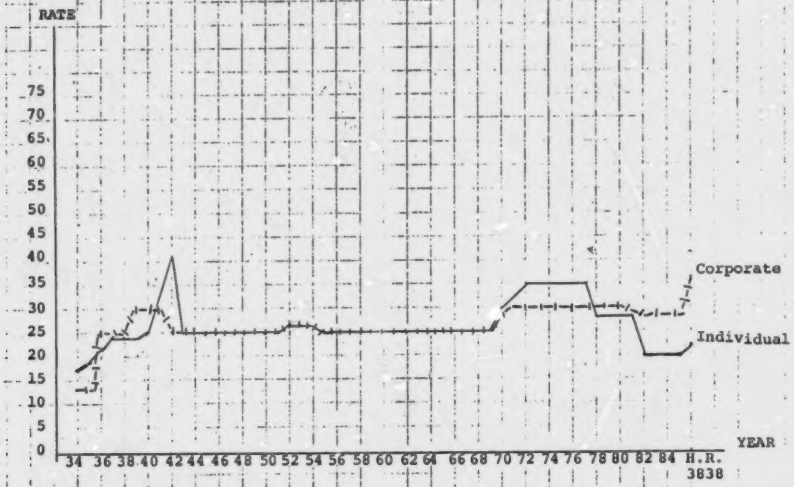
IV. Revenue Effect

Due to the small number of PHCs (in 1981, fewer than 5,000 corporations paid less than $5 million in personal holding company tax), any revenue effect attributable to taxation of PHCs will be relatively minor, particularly when contrasted with the dramatic effect the proposed individual ordinary rate cut from 50 to 38 percent would have. Nevertheless, a 22 percent PHC capital gains rate should actually result in greater tax revenue than the proposed 36 percent rate. Using the same assumptions underlying Exhibit B, Exhibit C demonstrates revenue effects in graphic form. At the present 28 percent capital gains rate, Treasury would collect $2.92 in taxes for each $100 in PHC assets, assuming a 50 percent turnover rate. If the capital gains rate is raised to 36 percent, the government would increase its tax collection to $3.32. But, as already discussed, the rational investor will decrease turnover in the face of higher capital gains taxes. If turnover is reduced to 30 percent, total tax collected would fall to $2.56 -- 12 percent less than was collected at the current 28 percent rate. Conversely, a capital gains tax rate of 22 percent would decrease the tax bill of a PHC with 25 percent turnover from the current $2.19 to $2.04. However, this would be more than offset by the increased likelihood of rational investor increasing turnover rate. As shown previously in Exhibit B, there will be very little increased tax penalty if turnover were increased to 50 percent, while such course of action would enable the investor to make more investments in growth stocks which could have a higher rate of return. If he were to follow that course of action, tax collected would rise by 15 percent, from $2.19 to $2.62, while at the same time the net rate of return would not decline significantly -- and would increase if the investor's prediction of enhanced growth were accurate.

V. Conclusion

Admittedly, during the course of its tax reform effort, the Committee will grapple with issues which affect more people and concern more revenue than the issue discussed herein. Nevertheless, it is important to strive for a rational Internal Revenue Code. The original design of the PHC provisions in 1934 was rational. The 1982 individual capital gains rate cut created a gap between individual and corporate capital gains rates which has inadvertently created an anomalous result in the PHC context. H.R. 3838 would increase that gap and thus exacerbate the anomaly. In order to restore the original and long-abiding purpose of putting investors on an equal footing regardless of their chosen investment vehicle, PHC capital gains should be taxed at individual, not corporate, rates. This would not only promote equity, but would enhance economic efficiency, promote capital formation, and increase federal tax revenues.

EXHIBIT A
COMPARISON OF INDIVIDUAL AND
CORPORATE CAPITAL GAINS RATES
1934 TO PRESENT



Note: for years 1934-1938, individual rates were on sliding scale depending on holding period; rate shown is lowest rate for longest period.

924

EXHIBIT B

EFFECT OF TURNOVER ON TOTAL RETURN AT VARIOUS CAPITAL GAINS TAX RATES

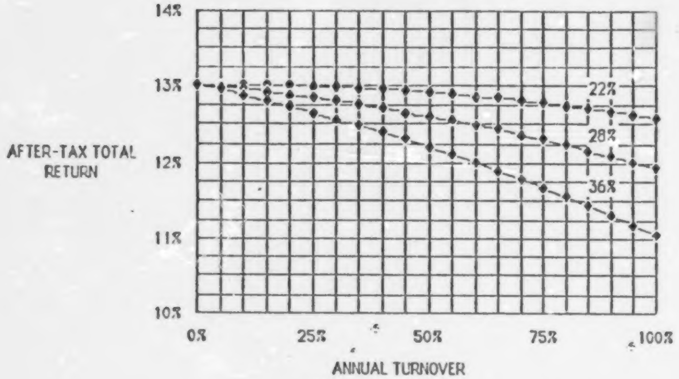


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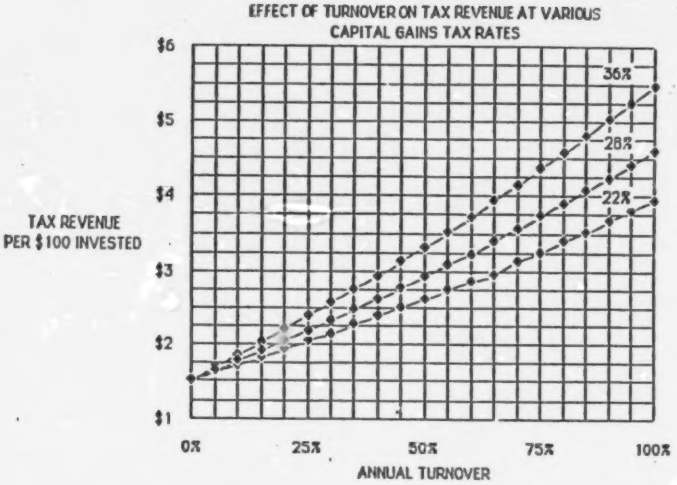
EXHIBIT C


EFFECT OF TURNOVER ON TAX REVENUE AT VARIOUS CAPITAL GAINS TAX RATES
TAX REVENUE PER $100 INVESTED
$6
$5
$4
$3
$2
$1
0%
25%
50%
75%
100%
ANNUAL TURNOVER
36%
28%
22%

J

THE JOHNS HOPKINS UNIVERSITY • APPLIED PHYSICS LABORATORY
Johns Hopkins Road • Laurel, Maryland • 20707

LABORATORY PENSION COMMITTEE
E. M. Portner, *Chairman*
P. A. Birck R. E. Fischell
R. A. Fletcher A. G. Schulz
L. A. Starliper W. N. Sweet
J. P. Rodgers, *Secretary*

PENSION COMMITTEE ADVISORS
H. C. Anderson
N. C. Dyer – Legal
B. Korenblit – Financial

18 February 1986

Refer to:
CPC-1107

Senator Robert Packwood
Chairman, Senate Finance Committee
259 Russell Senate Office Building
Washington, D.C. 20510

Subject: Statement on H. R. 3838

Dear Senator Packwood:

Enclosed for consideration by the Finance Committee is our statement on H. R. 3838, including recommendations for alternative approaches. We hope that you will give careful attention to the impact that this bill would have on university pension plans and that you will revise it to accomplish the desired revenue and reform objectives without unnecessary and unanticipated side effects.

Sincerely,

Edward M. Portner

Edward M. Portner
Chairman

Statement of

The Johns Hopkins University
Applied Physics Laboratory

on H. R. 3838

18 February 1986

Submitted by

Edward M. Portner
Chairman, Laboratory Pension Committee

Introduction

The Johns Hopkins University Applied Physics Laboratory (the "Laboratory") strongly opposes the pension provisions of H. R. 3838 (the "Bill"). For the reasons noted below, we believe that Title XI of the Bill would severely damage the pension plans of universities without providing any offsetting social benefit. We strongly urge that the current pension plan section of the Bill be deleted and that any necessary pension plan reforms be accomplished separately or by the substitution of more carefully crafted provisions such as the Retirement Income Policy Act of 1985 (S. 1784). Our comments below address specific problems with H. R. 3838 and contain suggestions for alternative approaches.

Background

The Laboratory is a division of The Johns Hopkins University formed to engage in scientific research and development for national defense. The Laboratory has approximately 2800 employees whose retirement benefits are provided under a program covering only our division of the University. Like many other employers in the academic community, our program contains an annuity and custodial account plan under Section 403(b) of the Internal Revenue Code. Contributions to this plan are made by employees either on a tax-deferred basis pursuant to a salary reduction agreement, or by voluntary after-tax contributions. In a related qualified money-purchase plan, the Laboratory contributes, up to a ceiling amount, one and one half times the amount contributed by employees under the annuity plan. It is our long standing policy that our employees contribute toward their retirement. Our experience has been that the powerful incentive provided by a 150% matching of employee contributions has resulted in wide participation and adequate savings for retirement.

Specific Concerns

Retroactivity

The effective date of the Bill, and the practical effect of many of its provisions, would cause substantial harm to some of our employees. Our matching contributions, although made on a semi-monthly pay period basis, are subject to a ceiling calculated on a prorated annual basis. Employees who have contributed more than the matched amount early in the year on the assumption that they can continue to contribute throughout the year will lose out on employer contributions in 1986 under the Bill. Specifically, those employees who reach the $7000 limit on individual contributions before the end of 1986 may be unable to contribute during the remaining pay periods and will therefore not receive additional matching employer contributions. Under the election rules for 403(b) plans the employees cannot adjust their deferral rate to prevent this problem. Certainly various provisions of the Bill will have similarly disruptive effects on other employers. We urge that any legislation follow the approach of S. 1784 and use a prospective rather than retroactive date.

The Bill contains other, more subtle, retroactive provisions. Under the Bill the taxation of distributions is completely revamped and the in-service availability of funds is severely curtailed. Our employees have made contributions and financial plans over long periods of time secure in the knowledge that their savings were available should the need arise. Furthermore, a premium of 1.5% was paid specifically for the option of cashable contracts. Ex post facto changes in these areas will inflict substantial inequities on those who have done the most careful planning and who have been the most conscientious about making adequate retirement provisions. In addition participation in our pension plans is likely to decrease because employees will justifiably lack confidence in the availability of their accumulations. In other words, the loss of accessibility and/or value imposed by withdrawal restrictions and penalties on previous contributions will destroy confidence in our pension plans in a manner no different from bad investments or theft of funds.

Linkage of 403(b) Plans, 401(k) Plans and IRA's

The Bill links 403(b) plans, 401(k) plans and IRA's in an attempt to have uniform treatment of pension plans. This approach is superficially appealing, but it fails to recognize that the different plans serve much different purposes despite the similarity of some of their features.

403(b) pension plans are the cornerstone of most college, university and non-profit organization pension systems, which have operated without abuse for decades. They were created in response to the special needs of tax-exempt organizations and they continue to serve that valuable function. As such, 403(b) plans should be viewed not only from the perspective of providing retirement benefits but also with an eye to furthering the charitable and educational purpose of organizations exempt under Section 501(c) of the Code. Tax-exempt organizations, by their very nature, cannot easily allocate the financial resources needed to set up a competitive, defined benefit pension plan common in industry. Annuity plans, with their unique combination of tax incentives and portability within the academic community, are used by educational institutions to attract and keep employees for whom they cannot otherwise compete on a dollar for dollar basis with the private sector. Thus 403(b) plans are an essential feature of many tax-exempt organizations.

In contrast, 401(k) plans are a relatively new supplement to the base of defined benefit plans for most of industry. 401(k) plans usually augment well established defined benefit plans. If Congress is dissatisfied with abuses of 401(k) plans due to excessive emphasis on tax sheltering rather than retirement, then this problem can be addressed through restrictions on 401(k) plans. There is no reason to severely damage core pension plans for universities in the process of modifying supplemental savings plans for industry.

The linkage of IRA's to 403(b) plans and to 401(k) plans illustrates the inappropriateness of thinking only in terms of uniform treatment. The combined contribution limit in the Bill was added to address a discrimination situation in 401(k) plans that does not exist for 403(b) plans. However, the limit also applies to 403(b) plans and would in effect preclude most of our employees from further IRA contributions. More generally, IRA's have evolved to the point of being a broadly available augmentation to Social Security and employer pension plans. If they are to be curtailed, then the restriction should be conditioned on the extent of participation in all pension plans, not just defined contribution plans.

Withdrawals

The Bill takes a punitive and unreasonable approach to withdrawals. The Bill's restricting of in-service withdrawals under 403(b) plans to true hardship situations reflects an understandable policy decision. However, given such a restriction, the newly added 15% early withdrawal penalty is too severe. There should be no penalty for valid hardship withdrawals. In addition, the criteria should include important social goals such as college education and home purchase.

More generally, the Bill fails to recognize the strong positive influence that accessibility to funds has on the extent of participation in retirement plans. Consider as an example education costs for children. Most young couples do not know with any certainty how many children they will have, whether the children will go to college and to graduate school, whether they will receive any form of financial aid, or whether the children may require some form of special education. Similar uncertainties apply to future medical expenses, home ownership, and retirement plans. Our experience is that our employees are much more likely to make adequate contributions to their retirement plan if there is a reasonable opportunity for them to make withdrawals to cover other equally important contingencies. A small fraction of our employees actually makes such withdrawals.

Any revision of pension law should preserve the accessibility of previous pension contributions to a cashable contract and should make reasonable provisions for withdrawals of new contributions under appropriate circumstances. A more restrictive approach would be counterproductive in that it would reduce private savings for retirement.

Contribution Limits

The primary function of retirement plans should be to promote adequate savings for retirement. Savings for other important activities such as education and home purchase are closely related and should not automatically be excluded for retirement savings plans. Defined contribution plans are a vital part of a comprehensive national retirement system because they allow individuals some flexibility in allocating their resources based on personal circumstances and goals. Allowing unlimited tax-deferred contributions would promote generally undesirable tax avoidance. Revenue considerations are also important. A limit to such contributions is clearly necessary, but setting the limit deserves careful consideration. Too low a limit would have a relatively minor effect on revenue but would inhibit the appropriate level of retirement savings.

The Bill drastically lowers the annual individual contribution limit to $7000 while setting the combined employer-employee limit at $25,000. It also effectively eliminates IRA's by reducing the $2000 IRA limit by the amount of employee contributions to an employer's plan. This approach must be seen as a first step in a program to eliminate employee participation and individual savings for retirement. The message of this provision is that employees should not have a substantial role in the responsibility for their retirement welfare.

A more appropriate approach is to set a limit bearing some relationship to the employee's salary (as does S. 1784) and to make the limit an aggregate for all employer and employee contributions to the plan. IRA's should not be included at all unless they are also coupled to defined benefit plans. However, if IRA's are included, they should be a part of the aggregate limit.

Non-Profit Status of TIAA/CREF

Paragraph 1012 of the Act would eliminate the tax-exempt status of TIAA/CREF. The rationale seems to be that there is no reason to subsidize a huge insurance company that is in competition with and indistinguishable from private sector companies.

TIAA/CREF serves exclusively non-profit organizations. Its size at this point is large because it has been effective in extending coverage to almost all such institutions and in promoting widespread employee participation. The case for or against its tax-exempt status should have nothing to do with its size. Its almost universal service to colleges and universities makes it valuable and unique. If it is appropriate to continue to have non-profit institutions, it continues to be appropriate to serve their pension and insurance needs via a non-profit organization.

There are also several practical reasons why this provision would do more harm than good. The principal function of TIAA/CREF is its management of $40 billion in pension funds. The costs of revoking TIAA/CREF's tax-exempt status would be large, and ultimately the pension funds would again be tax-deferred, just as they are now with TIAA/CREF (and just as they are now with every other insurance company). We question the wisdom of incurring major costs and creating widespread anxieties in order to eventually produce a new organization that is virtually indistinguishable from the old one in terms of its primary function. Furthermore, because of the costs and uncertainties during the transition period, many participants are likely to shift from TIAA/CREF to a competing 403(b)(7) plan. Thus the principal effect of this provision is likely to be to fragment the common pension system of colleges and universities.

We are not arguing for the perpetuation of TIAA/CREF regardless of its performance and value. In fact, our Laboratory offers to employees a 403(b)(7) plan as an alternative to TIAA/CREF. However, we do believe that TIAA/CREF should survive or wither on the basis of the quality of its service rather than due to the costs of a very expensive administrative effort, after which its pension funds would continue to be tax-deferred under other provisions of the code.

Summary

The Laboratory believes that the pension provisions of H. R. 3838 would severely damage our employee retirement plans without any proportionate public benefit. Pension law has been carefully and painstakingly developed over many years. This bill would seriously damage the entire structure of university pension plans in pursuit of a few revenue and mostly unrelated reform considerations. We believe that employee retirement income security is far too important to be treated in so short-sighted a manner.

We recommend that the special needs of educational institutions and their employees not be altered without adequate consideration of the consequences. We also urge that those employees who have carefully planned for retirement not have their lives disrupted by the retroactive practical effect of this legislation.

The Laboratory recognizes the need to make occasional adjustment in national retirement policy. However, H. R. 3838, which addresses primarily the tax and revenue aspects of retirement benefits, is not an appropriate vehicle for reform. We recommend that the Senate follow the approach of S. 1784 and address retirement policy in a comprehensive and equitable manner, with a concern for the long term security of employees.

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Attorney At Law

January 21, 1986.

Betty Scott-Boom
Committee of Finance   Room SD-219
Dirksen Senate Office Building
Washington, D.C.   20510

RE: H.R. 3838 Tax Reform

Dear Ms. Scott-Boom:

I would strongly urge that the Senate Finance Committee consider the impact of the proposed Amendment on the curtailment of existing Plans and the establishment of new Plans.

There is a balance between the discriminatory practice of excluding employees from contributions and benefits and reducing the benefits for the ownership group. If the establishment of Plans is not attractive to the ownership group of small employers, the ultimate losers will be the rank and file employees. The small business owner will find other methods to provide for his retirement while Government Programs will have to be increased to provide benefits which might otherwise be provided through Private Plans. Maintaining or even increasing the present Section 415 Limits should not result in a substantial revenue loss because the number of wealthy emplyers is quite small.

Sincerely,

Charles Ladd

Cl/rb

Lawrence University
Office of the President

February 17, 1986

Senate Committee on Finance
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Senators,

I write to you to express my great concern with several of the provisions contained in the Tax Reform Act of 1985 (HR 3838) that was passed by the House of Representatives in December, and with the impact these provisions would have on Lawrence University and other private colleges and universities.

The current policy on charitable contributions reflects a determination that charitable giving should be encouraged for the greater public good. Under the current law no taxpayer can completely avoid taxes simply by making a charitable gift. HR 3838 subjects charitable gifts of appreciated property to the alternative minimum tax. It places a $100 floor on the nonitemizer deduction, and imposes a $500 personal exemption reduction for those doners who itemize. When combined, these provisions discourage private charitable inititative and create a very negative climate for institutions such as Lawrence -- gift-dependent and already competing with tax-subsidized, low-tuition, and governmentally sponsored campuses. I find it curious, in an era of less government spending on domestic programs and after so much rhetoric espousing the value of private involvement rather than reliance on government

Box 599 Appleton, Wisconsin 54912

subsidies, that steps should be taken that will discourage private initiative in areas, such as education, that serve the public welfare.

HR 3838 would also seriously restrict access by private universities and colleges to tax-exempt bonds for financing needed construction and renovation of facilities. While the state volume caps impose detrimental restrictions for all non-profit organizations, private colleges and universities -- not public institutions of higher education -- face individual volume caps. This provision will negate the long-standing federal tradition of equal treatment for public and private sectors of higher education, both of which serve identical purposes.

You have recently heard the testimony of Mr. James G. MacDonald, Chairman and Chief Executive Officer of the Teachers Insurance and Annuity Association and College Retirement Equities Fund, regarding the elimination of the tax-exempt status of TIAA-CREF. I support his position and find it remarkable that HR 3838 singles out the pension funds of educational institutions for taxation while leaving the pension funds of all other organizations, whether they be tax-exempt or not, tax-free. It is also notable that HR 3838 seeks to discourage voluntary savings and planning for retirement by restricting the access of employees of educational institutions to elective tax-deferred annuities through reductions in maximum contributions and limitations or penalties on withdrawls -- a change that will only promote greater rather than less dependence on government retirement programs.

I appreciate that you have a difficult task before you, one that will require blending many individual concerns into a larger whole. What I ask here is that you view the issues I have raised above not as the concerns of one private college, but as matters that affect the future of a wide range of individuals and that make a statement about the values our society espouses. I urge you to ensure that the final legislation on tax reform will return these items to their current law treatment.

Sincerely,

Richard Warch
President
Lawrence University
Appleton, Wisconsin

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MACHINERY AND ALLIED PRODUCTS INSTITUTE

Statement of the
Machinery and Allied Products Institute
to the
Senate Committee on Finance
Concerning Capital Formation and
International Competitiveness Aspects
of H.R. 3838,
the Proposed
"Internal Revenue Code of 1986"

February 6, 1986

Statement of the
Machinery and Allied Products Institute
to the
Senate Committee on Finance
Concerning Capital Formation and
International Competitiveness Aspects
# of H.R. 3838,
the Proposed
"Internal Revenue Code of 1986"

February 6, 1986

Introduction

The Machinery and Allied Products Institute (MAPI) greatly appreciates this opportunity to comment to the Senate Committee on Finance in public hearings with respect to capital formation and international competitiveness aspects of H.R. 3838, the proposed "Internal Revenue Code of 1986," as passed by the House of Representatives on December 20, 1985.

The Committee will note from the record of hearings on tax revision held in the First Session of the current Congress that we presented our views on capital formation aspects of the subject legislation at an earlier stage on June 14, 1985; on international competitiveness on June 16, 1985; and on employee benefits on August 7, 1985. The House rendition of "tax reform," seen from our vantage point, does not differ markedly in thrust from the proposed legislation at the time of our earlier submissions. Accordingly, we take this opportunity to reiterate and emphasize certain fundamental convictions that we have about this entire exercise and the direction in which the Committee must move if major policy errors are to be averted.

In General

In that connection, we hasten to note that MAPI is not opposed in any generalized sense to tax revision. Indeed, an Internal Revenue Code that is used to promote social and economic ends as well as to finance general government requires constant surveillance and occasional adjustment to assure that intended purposes are being served.

Chronic deficit spending.--The Committee should recognize that fiscal prudence obviously is not manifested by *chronic* deficit spending. Moreover, the current imbalance of accounts cannot be attributed to a lack of tax revenues when federal receipts as a share of Gross National Product are slightly above their historical norm while spending obviously has been a runaway on the upside. Clearly, spending must be curbed, and such tax changes as occur should neither exacerbate the deficit in the short run nor impose any shock on major sectors of the economy that would jeopardize their participation for the long haul. Furthermore, any tax increases should be consumption-oriented.

The incongruity of H.R. 3838.--Given the existing slowdown in economic growth and capital spending, the fragility of the U.S. manufacturing sector, and the priority attention to be given to coping with deficits through spending restraint, we find H.R. 3838 to be an incongruity at the very least—as we will explain later. If the Committee continues this project on the scale originally proposed by the Administration and along the lines developed by the House of Representatives, we anticipate a further reduction of U.S. economic activity, still less savings and domestic investment, more outsourcing of production and production employment, and a weakened capability of the U.S. industrial base to mobilize in the event of an emergency calling for such response. These are sufficiently high stakes to warrant a serious rethinking of both the form and content of "tax reform," and either to shelve

H.R. 3838 if it is irreparably flawed or to scale back the project and extend its time frame.

In so stating, we are concerned by Chairman Packwood's contention that the political "chemistry" of the situation does not augur well for major changes in H.R. 3838 on the Senate side--assuming that the project is to go ahead. Even President Reagan now seems disposed (albeit belatedly) toward rectifying certain of the policy errors reflected in the bill. For that matter, the Committee is bound neither by the determinations of the House nor by the ambitious agenda set by the President. As many economists have already testified, H.R. 3838 is "beyond redemption." Under the circumstances, the Committee should provide leadership rather than the submission implied by the Chairman's remark. The Committee's decision to start from a "clean slate" is a step in the right direction.

In Summary

To summarize, we strongly oppose major portions of H.R. 3838. In significant part, the bill is blatantly anti-savings and investment;[1] extravagantly pro-consumption (on a fully effective basis); threatening to the international competitiveness of U.S.-based enterprises; and—contrary to the altruistic goals of its promoters--would be unfair to many taxpayers, would slow economic growth, and would vastly complicate an income tax law that already is an impenetrable morass.

High risk.--We repeatedly have advised both tax-writing committees that massive and sudden tax revision, as contrasted with incremental change, is a high-risk, low-return (or loss) proposition. Also, we reiterate that the top priority assigned by the White House to a massive reformulation of tax policy instead of urgent attention to the burgeoning budgetary and trade deficits was an error of incalculable potential consequence./1 Senators Gramm, Rudman, and Hollings are to be commended for their initiative in elevating the sensitivity of Congress to the budgetary hemorrhage, whether sequestration passes constitutional muster or not.

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[1] We seem to have been joined in this appraisal, to a greater or lesser degree, by Lawrence Chimerine of Chase Econometrics, Roger Banner of Data Resources, Inc., and George Shink of Wharton Econometric Forecasting Associates, Inc., in their statements to the Committee of January 29, 1986.

Inadequate hearings.—In our opinion, the "tax reform" dialogue—assuming for the moment that it is to continue—would benefit from much more thorough hearings than the Committee has scheduled. Any bill as extensive as H.R. 3838 involves a "learning curve" for those persons who would be affected, and Due Process is served only if the legislation is exhaustively examined at each step of the way to enactment or rejection. The Committee cannot dismiss this responsibility by holding five days of narrowly circumscribed hearings on H.R. 3838 and contending by way of excuse that numerous days of hearings were given to an earlier permutation of the subject. It is a commentary on the times that "retreats" with, and hearing panels composed of, disinterested experts from think tanks and academe are displacing more and more of the public hearing time once occupied by interaction of the Committee with aggrieved constituencies.

Uncertainty.—Also, while reviewing the legislation, the Committee should bear in mind that H.R. 3838 has introduced considerable uncertainty into decision making by all taxpayers, whether they would stand to gain or lose from ultimate passage. Neither of the nonbinding resolutions passed by the House (i.e., H.R. 335)

1/ Others who have taken issue with the assignment of priorities in this manner by the White House include Alan Greenspan of Townsend-Greenspan Co., Paul Craig Roberts of Georgetown University, and Murray Weidenbaum of Washington Universities, in hearings before this Committee on January 30, 1986.

and the Senate (i.e., S.R. 281) is sufficiently clear to allow consideration of the tax element in a decision framework, and prompt clarification is in order./1 If the Committee reports a bill, we believe that the effective dates and transitions should be designed so as to minimize disruption to all parties. Further, the Committee should review previous experiences with suspension or repeal of targeted incentives to capital spending before deciding on any such course of action--which, incidentally, we oppose.

Specific recommendations, in brief.--With respect to "capital formation" and "international competitiveness" aspects of H.R. 3838, the bill is woefully lacking. Congress cannot transfer some $140 billion of tax burden over five years (most of which amount would be attributable to the repeal of targeted capital formation incentives) to corporations from individuals and expect "business as usual." Moreover, Congress does not have the insular luxury of amending the U.S. income tax law without regard to the tax and regulatory milieu of foreign competitors of U.S.-based companies in world markets. In fact, the subjects of capital formation and international competitiveness are inextricably linked. Our recommendations concerning these attributes of H.R. 3838 are, as follows:

1. Preserve the Investment Tax Credit (ITC) as a permanent feature of the U.S. federal income tax law at such level as will, in conjunction with the cost recovery system, provide tax incentives for capital spending that are both significant and competitive when considered in an international context.

1/ Although the relative strength of the economy overall will have a direct effect on the capital spending plans of business in 1986, current projections of the Department of Commerce indicate a small decline in real spending (MAPI Bulletin 6623). Whether the proposed elimination of capital formation tax incentives is reflected to any extent in the projections is a matter for conjecture, but the uncertainty posed thereby certainly does not afford any stimulus.

2. Retain the Accelerated Cost Recovery System (ACRS) with such minimal changes as are necessary (a) to meet the criterion stated in item 1., above, and (b) to prevent erosion of cost recovery from inflation.
3. Leave the incremental credit for research and experimentation (R&E) at 25 percent; extend the credit indefinitely; and, only if necessary for administrative reasons, adopt a more sharply delineated definition to reinforce the intent that the incentive be directed to innovative activity. Serious consideration should be given to allowing a full credit without regard to base period performance.
4. Retain the overall limitation on foreign tax credits, and reject the proposed proliferation of separate limitations (or any other approach, such as the "per country" method) that is intended to defeat or lessen the averaging of high-taxed and low-taxed income from abroad. Also, retain existing "source" rules applicable to items of income and expense for purposes of computing the foreign tax credit limitation, including the required allocation of U.S.-based research expense to U.S.-source income, and reject proposed changes that deviate from reasonable norms and arbitrarily find more income to be domestic and more expense to be foreign.
5. Reject proposals to increase the current U.S. taxation of unrepatriated earnings derived from various "active" businesses of controlled foreign corporations.
6. Forego action on the completed-contract method of accounting at this time, and, instead, commission an independent study of the method (a) to determine whether the 1982 tax law restrictions

applicable thereto (just becoming fully effective) will achieve their stated purpose; and (b) to report back to Congress not later than 12 months following the date of enactment. The study should include information on methods of tax accounting authorized for long-term contracts in other major trading nations.

7. Reject changes in the individual and corporate minimum taxes that would work at cross-purposes with other Code provisions that facilitate capital formation and international competitiveness. The minimum taxes are a policy abomination and should not be enlarged absent showings of abuse that cannot be dealt with otherwise. Moreover, any expansion of the device should include equitable transition rules.

8. Do nothing to detract from the Foreign Sales Corporation (FSC) provisions that became effective only one year ago. The benefit of FSC to U.S. export activity is modest in relation to that enjoyed by our competitors abroad, and existing trade deficits make any reductions in the incentive both untimely and unwise. Also, policy instability with regard to incentives of this kind is self-defeating and grossly inconsiderate to taxpayers.

9. Increase--rather than reduce--the maximum annual exclusion for foreign earned income of Americans working abroad so as to approximate the value of the exclusion when it was enacted more than 20 years ago, and reject the addition of excluded amounts to the list of preferences subject to the minimum tax. The failure of Congress to deal decisively with erosion of the exclusion is pricing U.S. nationals out of many key jobs overseas with

branches and affiliates of U.S.-based companies. There are adverse trade implications as well.

10. Reconsider all provisions applicable to employee benefits in terms of equity to potentially affected parties and consequences for the rate of savings by individuals. Inequitable provisions should be rejected, and those that would reduce savings should be reevaluated in the context of the entire bill as it would impact adversely in this manner.

The remaining portion of this statement sets forth in somewhat greater detail our thoughts concerning those provisions of H.R. 3838 that need the most attention on the Senate side from a capital formation and international competitiveness vantage point if the bill is to go forward.

Background

H.R. 3838 is an outgrowth of what began as a presidential pledge to revise the federal income tax system to make it simpler, more fair, and more conducive to economic growth. In November 1984, the Department of the Treasury produced a study with recommendations for carrying out the pledge. In late May of 1985, President Reagan adopted the plan with certain changes aimed at making it more palatable to vocal constituencies. Hearings were held in the tax-writing committees to gauge public sentiment and ascertain the need for further changes in the proposal. Subsequently, the House Committee on Ways and Means conducted a stormy two-month series of mark-up sessions. H.R. 3838 was reported favorably on December 7, 1985, and the bill was passed by the House of Representatives on December 17, 1985, partly on the strength of President Reagan's personal intervention to assuage opponents of the measure.

The concept that underlies the current "tax reform" effort is relatively straightforward. Over time, the federal income tax has gained many special purpose deductions, exclusions, exemptions, credits, preferential rates, and similar concessions that erode the tax base and force tax rates higher to generate the same revenue yield. Tax revisionists argue that these concessionary provisions complicate the Internal Revenue Code, impair market efficiency by injecting tax elements into decision making, and cause inequities among taxpayers having dissimilar access to tax preferences. For those who accept this line of argument, the cure entails lowering tax rates generally and repealing as many tax concessions as possible. If the restructuring has "revenue neutrality" as one of the parameters, then the lowering of tax rates (i.e., the revenue-losing items) is to be offset in equal dollar amount by the repeal of tax concessions (i.e., the revenue-raising steps). Relative burdens among taxpayer groups (e.g., corporations and individuals) or within taxpayer groups (e.g., as between capital-intensive and labor-intensive corporations) may or may not be shifted depending upon the objectives and whether they win popular support.

For the business community, several aspects of H.R. 3838 seem to dominate the dialogue and polarize the response. One such aspect is the overall shift of some $140 billion of tax burden over five years to corporations and away from individuals, largely as proposed to be accomplished by repealing targeted incentives to savings and capital formation and redistributing the revenues so gained by means of general rate reductions. The bill has a serious bias against savings and capital formation, and the bias is so pervasive that it is a cause for alarm. Another facet of H.R. 3838 that attracts unfavorable reviews is its apparent disregard for the highly competitive, international environment in which affected taxpayers operate. Although opinions differ somewhat, most responsible commentators believe that the bill will have a damaging impact on business investment and international competitiveness. Whether it is wise to skew tax policy in this way is questionable under the best of conditions and strikes many observers as foolhardy under the circumstances that prevail./1

Any discussion of tax increase, decrease, or "revenue neutral" restructuring must take into consideration both economic conditions generally and the probable consequences for sectors of the economy that would be favored or disfavored by the changes under examination. Indeed, a threshold factor is whether tax revision is generally perceived as being needed at all inasmuch as national policy should be driven by public opinion and not established by fiat. To take this latter element first, the Committee should recognize by now that there is no "groundswell" of public support for a wholesale rewrite of the Code, notwithstanding the enthusiastic support of a popular President and the anxious efforts of the Opposition Party to leave its imprint on the project. Recent polls by the Wall Street Journal and other organizations indicate not only that greater public concern is assigned to the deficits, but also that there increasingly is an undercurrent of doubt associated with "tax reform." When presumably dispassionate, indifferent economists declare that H.R. 3838 is "beyond redemption" and when the public is "turned off" by the endeavor, one would hope that Congress would get the message.

Regarding the economy, H.R. 3838 would wreak some havoc in the short run, whether or not it is true that a new equilibrium would be found after a transitional period. Within MAPI's membership, many major manufacturers in such industries as construction, farm, mining, oil field, railroad, and steel mill equipment and machine tools have yet to experience meaningful recoveries from the double-dip recessions of

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1/ MAPI research concludes that the federal government should adopt a mix of fiscal and monetary policies that would increase the rates of savings and investment and result in lower interest rates, among other corrective actions, and that tax proposals should be judged for their timeliness in light of weakness in the manufacturing sector as well as their likely effects on savings and investment and international competitiveness. A Portrait of U.S. Manufacturing—Are the Wrinkles Showing?, MAPI, December 1985.

1980 and 1982, notwithstanding drastic cost reduction programs and increased outsourcing of production.[1] Meanwhile, other member companies that recovered from the slump--as was the case in such diverse industries as heavy duty trucks and semiconductors--have since receded. One conspicuous cause of this has been much more severe foreign competition from companies benefited by a relatively strong U.S. dollar, relatively low labor costs, heavy government subsidization, and generally free entry into U.S. markets coupled with significant barriers to U.S. entry into many foreign markets. Also, the rapid pace of disinflation, while not disadvantageous to most manufacturers, has caused dislocations (e.g., in the farm economy) that have had a negative effect on parts of the manufacturing sector.[2]

If national tax policy of a non-protectionist character--which we support--is to have a role in stemming this tide instead of accelerating it, several propositions become apparent. First, the federal income tax must favor U.S.-based research because research is the leading edge of technological innovation, which is a critical factor in international competitiveness. H.R. 3838 is not satisfactory on this score. Secondly, our tax law must encourage personal savings--which currently is low but would be lower without existing incentives--and all forms of individual and business investment.[3] H.R. 3838 is a disaster on this score. Thirdly, our tax law must not disregard the fact that U.S.-based companies compete both abroad and in the United States against foreign competitors that may have significant advantages in the marketplace due solely to foreign tax preferences or other governmental support. H.R. 3838 reflects no awareness of this element, and, in fact, tilts the "playing field" against our team.

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[1] A recent MAPI survey shows significant growth in the percentage of surveyed companies' U.S. purchases accounted for by foreign sources. MAPI Survey on Global Sourcing as a Corporate Strategy--An Update, MAPI Memorandum G-200, February 1986.

[2] A more complete analysis of disinflation's impacts is contained in the MAPI study entitled The Agony and the Ecstasy of Disinflation, MAPI Memorandum G-198, January 1986.

[3] In The Capital Goods Recovery: Why Some Lag Behind--Part II, MAPI analyzed long-term shifts in the pattern of investment spending and concluded, among other findings, that "this is not the time to weaken capital investment incentives in the tax system." MAPI Capital Goods Review No. 124, May 1985.

The comments that follow are general in nature, although patterned in response to portions of H.R. 3838, consistent with the Committee's stated intent to review "tax reform" de novo rather than with the House-passed bill as the launchpad.

Whither "Tax Reform": Some Specifics

The Investment Credit

The regular investment tax credit would be repealed under H.R. 3838, effective generally for property placed in service after December 31, 1985. However, the credit would be available for eligible property to which transition rules apply for depreciation purposes. Such credits generally would be allowable ratably over a five-year period, and a full adjustment in depreciation basis for the entire credit would be required when property is placed in service. These changes are estimated to cost corporations $97.8 billion and individuals $22.5 billion over the five fiscal years, 1986 through 1990.

Comment.--As we indicated earlier, we believe that this country should have an investment tax credit that, when coupled with the applicable cost recovery system, is both significant and competitive taken in an international context.

Economists before the Committee have testified to the effect that the investment credit is the incentive that provides the most "bang for the buck" in terms of capital formation. This has been the conventional—and accurate—wisdom since President Kennedy proposed the credit some 25 years ago. Moreover, the credit is available only if qualified expenditures are made, and businesses of any size or form of organization are eligible to claim it. Until the gap in compensation costs among countries is smaller, vital U.S. industries will be competitive at home and in world markets--at least for goods that are not totally unique--only to the extent that greater productivity through modern plant and equipment can substantially offset the labor-cost disparity./1

Returning to our primary recommendation, recent research performed by the independent accounting firm of Arthur Andersen & Co. with respect to tax incentives for capital formation in sixteen major trading nations shows the United States currently ranked about midway. The changes proposed in H.R. 3838 would place this country somewhere near the bottom of the group, with most of the damage attributable to repeal of the investment tax credit. The credit works as intended in business investment because the cash flow from the credit normally is factored into major investment decisions using discounted cash flow analysis. If the credit were to be removed, then the cash flow that it otherwise would generate would not be available to augment other flows in judging whether a proposed capital appropriation meets the investor's minimum expected rate of return for the approval of spending proposals.

In short, repeal of the credit would increase the cost of capital in this country./2 In so doing, it would slow business investment, which will be modest in 1986 without further retardation by policy change; would slow productivity growth, which already is slowing without the "help" of credit repeal; and probably would slow growth of the Gross National Product in the long run, with concomitant negative impacts on employment and disproportionately adverse effects in the U.S. manufacturing and housing sectors.

Finally, the credit is not interchangeable with rate reductions because the former is "targeted" to business investment--which we need--and the latter are

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1/ This contention is documented in MAPI research entitled The Gap in Compensation Costs Among Countries: The U.S. International Competitive Situation Worsens, MAPI Memorandum G-191 of October 1985.

2/ According to testimony received by the Committee on January 20, 1986, from George Shink of Wharton Econometric Forecasting Associates, Inc., the average increase in the cost of capital as of 1995 would be 12.5 percent.

undirected to any purpose and, therefore, highly likely to go for consumption at the expense of savings. We acknowledge that Congress could provide a cash flow incentive to capital spending equivalent to that of the current arrangement through means such as the front-loading of cost recovery. However, since the investment credit and cost recovery system already have been changed too frequently, we would prefer to have the credit left as is. Even if the credit is suspended, we suggest that the device be left in a state of readiness for reactivation or increase in response to changing economic conditions, including any further relative decline in the U.S. manufacturing sector. Moreover, the effective date of any negative action on the credit should be postponed at least until January 1, 1987.

Capital Cost Recovery

If H.R. 3838 were enacted, the Accelerated Cost Recovery System (ACRS) would be replaced by the Incentive Depreciation System (IDS), effective generally for property placed in service after December 31, 1985, except for property covered by transition rules. IDS would group assets into ten classes, generally according to their Asset Depreciation Range (ADR) midpoint life, and the assets would be depreciated over a common period ranging from three to thirty years. The 200-percent declining-balance method, switching to the straight-line method, would be used for classes one through nine; the straight-line method would be used for class ten, which would include primarily real property other than low-income housing.

IDS deductions would be subject to increases for inflation adjustments, beginning in 1988. In general, the adjustments would be for half the inflation rate in excess of five percent in applicable years.

A nonincentive depreciation system would apply for certain other purposes.

Comment.--For all the reasons set forth earlier in discussion of the investment credit, our capital cost recovery system should complement the investment credit in giving American businesses significant capital formation incentives. H.R. 3838 fails this test, and its IDS is part of the reason. We also believe that national policy should assure that U.S. businesses never again are subjected to the perverse situation of the 1970s and early 1980s in which taxpayers were denied a fair recovery because policy did not take account of inflation. The inflation adjustment that would be provided in IDS would be thoroughly inadequate.

The existing ACRS of 1981, coupled with the enhanced investment credit, was an enlightened response to speed cost recoveries, and, at the same time, to simplify a system that was unduly cumbersome. Now, only five years later, "reform" proponents wish to cut back on recovery allowances and to differentiate more among assets because the current arrangement allegedly is "too generous" and the varying effects among similarly situated taxpayers ought to be lessened. To achieve these "refinements," IDS basically would revert to the anachronistic 1971 ADR system. The projected net cost to businesses of this change, plus or minus certain amendments to expensing for small companies: $19.8 billion for corporations; and $5.2 billion for individuals. Adding this to the amounts previously shown for the investment credit, we have a combined "hit" to targeted capital formation incentives of roughly $145.3 billion, some unidentified amount of which would find its way back into the investment stream but another unidentified portion of which would not.

We would like ACRS preserved with as little change as is necessary to meet our objective already repeatedly stated for the ACRS and investment credit as a package. The reason for minimizing change to ACRS also is readily apparent if only because the lack of consistent policy causes administrative burden and uncertainty. Some businesses already must operate with numerous depreciation systems side-by-side, including ACRS for certain assets, ADR for others, and facts-and-circumstances for still others. Some states follow the federal approach and others do not, compounding a situation that already is costly without adding one iota to output and simultaneously imposing inordinate overhead expense. In reviewing IDS, Congress further will recall that one purpose of ACRS was to get away from notions of economic service lives in the interest of simplification and fewer taxpayer-Internal Revenue Service disputes. Stated otherwise, we think that there is little to gain from tinkering with ACRS, and that a retreat to the obsolete concepts of ADR would be a mistake.

More than a few sages have stated that the best thing that could happen for a few years or so by way of tax legislation is "nothing." We concur, especially as it concerns the sensitive issue of cost recovery in general and ACRS and the investment credit in particular. The Committee may recall that ACRS has been pared back several times since original enactment. Now, yet another overhaul of the system is in prospect with an obvious bias toward increasing the cost of capital but no clear indication of when the new regime would take effect. The uncertainties of proposed tax law amendments and their expected effective dates (and transitions) interfere with business decisions, and we oppose yet another system overhaul so soon after the others in the absence of compelling circumstances.

The Research Credit

H.R. 3838 would extend the credit for increasing research activities for an additional three years, i.e., for qualified research expenditures paid or incurred through December 31, 1988. In addition, the bill would modify the credit as follows, effective for taxable years beginning after 1985: (1) the credit rate would be reduced from 25 percent to 20 percent; (2) rental and similar payments for the use of personal property would not be eligible for the credit, except for certain payments for computer time; (3) the definition of qualified research for purposes of the extended credit would be modified to direct it more narrowly to innovative activity; (4) increased tax incentives would be provided for corporate cash expenditures in excess of certain floors for basic research at universities and certain other

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organizations; and (5) the general limitation on use of business credits, as proposed under the bill to be reduced to 75 percent of tax liability over $25,000, would apply to the research credit.

Comment.--It is relevant here to quote from "Global Competition--The New Reality,"/1 as it pertains to tax incentives for research and development:

> R&D conducted by industry is critical to competitiveness and should be encouraged through enhanced incentives: making permanent the R&D tax credit of the current tax law; broadening the definition of R&D qualifying for the tax credit; implementing a tax credit based on total R&D as a substitute for the incremental R&D tax credit; permanently repealing the research allocation rules to remove the incentives in the present law to shift R&D overseas (Treasury Regulation Section 1.861-8); and creating a preferential tax credit to encourage further industry investment in university research.

H.R. 3838 does virtually nothing recommended for R&D by the President's Commission on Industrial Competitiveness. To the contrary, the bill goes the opposite way on nearly every recommendation. First, the bill does not make the R&D tax credit permanent, but instead would only extend it for three years. This is hardly satisfactory considering the time horizon for the planning, budgeting, and conduct of research activity. By failing to provide a permanent credit, Congress leaves companies facing the prospect of expiration of the credit, which means that it is less than wholly reliable in generating cash flow for qualified purposes. To the extent that it is unreliable, the credit is less efficient than it should be. Indeed, for failure to act in a timely manner on expiring tax provisions at year-end 1985, the R&D tax credit currently does not exist other than in vague commitments to try to have it extended retroactively to its expiration date.

The President's Commission would broaden the definition of R&D qualifying for the tax credit whereas H.R. 3838 would narrow the definition. Given current difficulties of administering the credit, we do not quarrel with the purpose of the

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1/ "Global Competition--The New Reality," the report of the President's Commission on Industrial Competitiveness, January 1985, Vol. 1.

bill to limit the credit to costs of carrying out activity that is truly innovative. On the other hand, "research and experimentation" is not easily subjected to precise classification. If the definition in the law is too lax, there will be an element of noncompliance; if the definition is too prescriptive, some bona fide R&D will be lost. In our opinion, a fair definition must leave something to the judgment of taxpayers and auditors, and not attempt to be all-inclusive. Also, such a definition should be developed in close cooperation with taxpayers.

There is merit to the recommendation of the President's Commission that a research credit be allowed for the entire amount of qualifying costs incurred rather than the increment over a base-year period. As the credit now is designed, a taxpayer must constantly "run faster just to stay in place." While this is interesting in theory, one wonders about its practicality in the real world where business cycles and factors beyond the taxpayer's control have a bearing on whether or not the research budget can increase without interruption. If an incentive is to be provided to R&D because that activity is valuable, is it reasonable to reward only the increment over a base period or should all qualifying amounts be eligible? Is there something less valuable about R&D activity that is performed this year but does not happen to exceed the average amount for the base period? We believe that these questions answer themselves and argue well for a more predictable incentive applicable to all of this vital activity.

Concerning the research allocation rules used in connection with computation of the foreign tax credit limitation, the President's Commission again is on target with a recommendation to settle an argument that has raged for over a decade and to do so in a manner that clearly is in the national interest. To allocate U.S.-based R&D to foreign income is questionable at best when no income at all normally is derived from research in the year in which it is performed and when the connection between U.S.-based R&D and foreign income is not only separated in time but is tenuous in terms of cause-and-effect. The practical consequence is to reduce foreign source income, which in turn reduces the foreign tax credit limitation. To the extent that an amount of otherwise qualified foreign tax credit becomes ineligible because of the reduced limitation attributable to a spurious allocation, the taxpayer is subjected to some duplicative tax burden most assuredly not borne by his competitors. U.S.-based R&D should not be allocated to foreign source income, and "tax reform" should settle the matter once and for all.

We cannot overemphasize the importance of R&D tax incentives.[1] They are an extremely valuable—and, we think, cost-effective—use of resources, and are best dispensed through the Code to minimize bureaucratic interference and maximize private-sector latitude in response to the ever-changing marketplace.

The Foreign Tax Credit

Under H.R. 3838, the overall foreign tax credit limitation of present law would be retained, with separate limitations for passive income, shipping income, foreign currency translation gain, and banking and insurance income—among other changes. The "source" rules used in the allocation of income and expense to sources within or without the United States for—among other purposes—computation of the foreign tax credit limitation would be altered in a host of ways apparently intended to support findings that more income than previously has been the case is U.S.-source and more expense than previously has been the case is foreign-source.

The limitation rules would be effective for taxable years beginning after 1985, and the source rules generally would be effective for taxable years beginning after 1985, although certain transitional relief would be provided.

Comment.—There is very little—if any—division in the business community in its position with respect to these items of H.R. 3838. Virtually all affected parties are opposed because of increased tax burdens that would be unfairly imposed on and unilaterally borne by U.S.-based taxpayers and because of administrative complexity that would be boosted by quantum leaps.

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[1] A recent MAPI study underscores the importance of maintaining pro-R&D policies across the board. MAPI Memorandum G-192, October 1985, R&D Spending—A New Profile.

If we may focus on the "highlights," the bill would attempt to defeat the averaging of high-taxed income and low-taxed income from different countries--i.e., the hallmark of the overall limitation--by creating a proliferation of separate limitations applicable to generally low-taxed types of income. If the Committee is interested in international competitiveness, it should not accept this proposal because "averaging" is not now--and never was--illegal or abusive. In fact, other countries with sophisticated systems of income taxation either exempt foreign source income from taxation; employ an overall limitation that operates more or less like our own; or have a "per country" limitation that allows averaging through the use of offshore holding companies. The amendments proposed by H.R. 3838 do not accord with international conventions, and would seriously increase the costs to U.S.-based enterprises of doing business abroad--a competitive handicap that they cannot afford.

The proposed source rule amendments fit hand-in-glove with the punitive limitation changes, and would assure that the limitations are forced down to lower levels reducing the availability of foreign tax credits. Although a number of these provisions concern us, we are particularly distressed by those pertaining to income derived from the purchase and sale of inventory-type property and the allocation of interest. In the former instance, source generally would be determined by the country of residence of the seller, and the place-of-title-passage source rule of present law would be repealed. An exception would apply where a seller has a fixed place of business outside of his residence country that participates materially in a sale to an unrelated party, in which case the sales income generally would be sourced in the country in which that fixed place of business is located. As to interest, the bill generally would require corporate members of affiliated groups to allocate all expenses between U.S. and foreign income on a consolidated group basis using a modified asset method of allocation.

With respect to sales of inventory-type property to nonaffiliates where the seller has no fixed place of business abroad that participates materially in the sale and the company selling the goods currently sources the income abroad through some mutually agreed contractual term for title passage abroad, we can foresee two possible results. Either the seller would suffer a tax increase attributable to his export sales or he would make sure that a fixed place of business outside the United States participates in the sale. We do not know why this proposed change would be made, other than to attempt to increase taxes by turning the rules against taxpayers in a case where sourcing admittedly is somewhat subjective. We think the title passage rule to be as good a determinant of source as any inasmuch as title passage is important for many purposes in the law and the location thereof is a negotiable item in a contract. We also are concerned that the change in the source rule would run counter to the policy recently established in favor of exports in the form of Foreign Sales Corporation (FSC) tax incentives. Any conflict here would provide another reason for dropping the proposal.

As to the plan to change the allocation of interest, the subject last received serious attention more than a decade ago when Income Tax Regulation Section 1.861-8 was proposed, reproposed, and eventually adopted. We took exception then to using a notion of fungibility of money in this context, and we do not feel differently today. We rather expect that allocations in accordance with the proposal of H.R. 3838 would be arbitrary and, in many instances, very illogical. In view of this, we further suspect that proponents of the idea have no principal purpose other than that as much expense as possible be allocated to foreign source income in order to defeat foreign tax credits. Economic reality would be "out the window," and fungibility with all its bizarre ramifications would be "off to the races."

"Deferral"

Certain forms of "passive" income earned abroad generally are taxed currently (i.e., are not deferred) to the U.S. parent company, whether remitted or not, if earned by controlled foreign subsidiaries. Under H.R. 3838, various exceptions to the Code's rules that currently tax certain "tax haven" income of foreign subsidiaries of U.S. companies would be repealed, including the exclusions for some "active" business income of banks, insurance companies, and shipping companies.

Comment.—As the Committee is aware, most income of foreign subsidiaries of U.S. companies is not taxed by the United States until it is repatriated, and the situations giving rise to immediate taxation in the United States without regard to repatriation mainly arose because of "abuses" involving "tax havens." Also, one of the key distinctions in the doctrine of current taxation--as compared with "deferral"—involves the distinction between passive and active income. We object to tax law changes that would increase the incidence of current taxation with respect to active income. If the "active/passive" differentiation is disregarded in the cases proposed, so-called "reformers" will be out to scuttle it for all purposes. These provisions would constitute a drain on the cash flow of U.S.-based enterprises engaged in worldwide competition against foreign-based firms that bear no similar burden. Accordingly, the proposal should be rejected.

Completed-Contract Method of Accounting

Under H.R. 3838, the completed-contract method of accounting would be repealed except for certain contracts involving real estate construction. Contracts taking more than one year to completion would have to be reported on the percentage-of-completion method. Interest would be paid by (or to) the taxpayer if the reported profit on a contract each year were to be more (or less) than a portion of the actual profit on that contract allocable to that year. This provision would be effective for long-term contracts entered into after December 31, 1985.

Comment.--We oppose repealing the completed-contract method of accounting that has existed in the federal income tax law very nearly from its beginning, and, further, believe that the proposal is untimely. The reason for having a completed-contract method of accounting which defers recognition of taxable income until contract completion is to take into consideration the unique circumstances of producers and constructors with long lead-times to completion, including increased vulnerability to unpredictable occurrences that could turn profitable contracts into losses. If taxability were not to be determined at contract completion, taxpayers with long-term contracts might be subject to tax at interim stages of transactions that culminate as losses. Furthermore, even when such taxpayers receive progress payments along the way, such payments often do not cover costs incurred, and amounts more than equivalent to expected profit margins frequently are withheld by customers as "retainage" pending certification of satisfactory completion or some other measure of performance to specification in accordance with the terms of the contract.

The controversy in this area has involved deferral of tax on anticipated income from a contract while claiming certain deductions related to the transaction during the course of performance; occasional deviations in interpreting eligibility; and the aggregating and segregating of transactions in questionable or inconsistent ways in order to derive tax advantage. As the Committee may know, all of these issues were addressed in a set of comprehensive reforms enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 and final regulations implementing the law were just issued recently. Moreover, the 1982 revisions were so severe that they were deliberately phased in over a period encompassing 1983, 1984, and 1985.

Accordingly, much of the recent "shouting" about companies that use the completed-contract method of accounting and file tax losses while reporting financial gains is information that antedates all or part of the transition period with respect to the 1982 amendments. The transition period now is ending, but the full effects of the 1982 changes have not yet been reflected in tax returns.

If the Committee wishes to proceed—as we know it does—circumspectly and with due regard to the facts, rather than haphazardly on misinformation, then we suggest commissioning an independent study of the method to determine whether the 1982 tax law restrictions will achieve their stated purpose and to report back to Congress not later than 12 months following the date of enactment—assuming that this is a suitable time span—with findings and recommendations. To embark on more policy change without an accurate information base is as untidy as it is premature. Let us add that some of the taxpayers that have been pilloried in the press on this issue are now becoming major taxpayers as the 1982 amendments take effect.

The Minimum Taxes

Under H.R. 3838, the existing corporate and individual minimum taxes would be beefed up in order to deal indirectly with some tax preferences that are amenable to chipping away by indirection but have enough of a constituency to fend off direct "reform." We will not delve into the details of the proposed changes inasmuch as our comments are general in nature.

Comment.--The minimum taxes for corporations and individuals that were enacted in the Tax Reform Act of 1969 and subsequently amended from time to time are a product of frustration, a frustration borne out of the desire to retain various incentives in the Code while at the same time preventing their "exploitation" by persons bent on "zeroing out" their tax returns. From the time of Treasury Secretary Barr's revelation in 1968 that many wealthy people were paying no taxes, the Department of the Treasury periodically has kept the cauldron brewing by reporting that still more work remains to be done. Whether one agrees with it or not, the "fair share" frame of mind will not be denied, and the minimum taxes have been the chosen vehicle of "reform" when nothing else would work. We are not so ingenuous as to think that minimum taxes will go away, but we do want to continue to spotlight certain of their peculiar features.

First, the minimum taxes work at cross-purposes with other Code provisions that were put in place to do such things as facilitate capital formation and international competitiveness. To the extent that they succeed, they thwart the accomplishment of those purposes. Obviously, the better way to set policy is to do so forthrightly rather than via the backdoor route. Further, the minimum taxes complicate the Code and add significantly to the burden and cost of tax return preparation. One of the highly objectionable aspects of the proposal contained in H.R. 3838 is that the minimum tax rate would be set at an inordinately high level and in such close proximity to the proposed maximum marginal regular tax rate that many taxpayers would be required to compute their tax returns in accordance with two separate systems to determine which of the two governs. Also, some taxpayers would find themselves more or less regularly paying a minimum tax rather than the conventional tax.

We also believe that any toughening of the minimum tax—assuming that such change is favored by the Committee—should be accompanied by equitable transitions. For example, the incentive depreciation add-backs contemplated by H.R. 3838 could be very sizable, and the bill does not take into consideration the circumstances of businesses with long-term fixed-price contracts that have no provision for price adjustment to account for changes in the tax law. This is totally inappropriate, and we believe the Committee should be mindful of transitions here and wherever else tax increases are under review.

If the Committee does not wish to impede capital formation and international competitiveness and does not want to introduce more complexity into the Code, then we suggest that the proposals for change in the minimum tax be examined for conformity or lack thereof with these objectives and be rejected if they would detract from such purposes.

Foreign Sales Corporation

H.R. 3838 changes the reduction in taxable income for FSC shareholders from 16 percent to 14 percent of export income (from 15 percent to 13 percent for corporate shareholders). Corresponding changes would be made to the Domestic International Sales Corporation rules, and the provision would be effective for taxable years beginning after 1985.

Comment.--We think the Committee should be aware that policy instability with regard to incentives of this kind is self-defeating and grossly inconsiderate of taxpayers. The FSC provisions are only one year old, and they were enacted as a response to significant export incentives enjoyed by our competitors abroad. The idea behind FSC was to put in place a mechanism for conferring a small amount of benefit to U.S. export activity using a concept of territorial jurisdiction that would not be offensive to the General Agreement on Tariffs and Trade, to which the United States and many other major trading nations are signatories. The United States has significant trade deficits that would be worse in the absence of the relatively small FSC incentive, and we find it both untimely and unwise to begin paring back the device under such circumstances only a year after enactment.

Foreign Earned Income

H.R. 3838 would reduce the maximum annual exclusion for foreign earned income of Americans working abroad, from the present $80,000 to $75,000. Also, the excluded amount would become a minimum tax preference item. The provision would be effective for taxable years beginning after 1985.

Comment.--Code Section 911 was enacted in the early 1960s to provide an exclusion of $50,000 for U.S. workers with overseas duty of a specified duration. The purpose was to prevent overlapping U.S. taxation of income earned by such individuals because most other countries did not tax their nationals on earnings from working abroad. With the passage of time, inflation seriously eroded the exclusion, to the point that employers--who often provide tax equalization for their U.S. taxpayers at foreign worksites--gradually found it very costly to employ Americans. In 1981, Congress attempted to rectify this situation by scaling up the exclusion over a period of years to $95,000. Later, the transition period was stretched out as part of the Deficit Reduction Act of 1984. Today, the "remedy" still is so inadequate that a company wishing to employ an engineer or executive abroad can consider a U.S. taxpayer only if it can afford to pay an enormous premium over the going price for a foreign national of similar stature.

Now, H.R. 3838 would "turn the clock back" and raise the cost to still higher levels by reducing the exclusion and listing excluded amounts as a preference. This does not strike us as reasonable legislation, and we should add that there are adverse trade implications as well if the decision to employ a foreign worker results in foreign sourcing of goods that otherwise might be supplied from the United States. We hope that reason will prevail, and that the Committee will reject this short-sighted item in H.R. 3838.

Employee Benefits

H.R. 3838 contains many changes applicable to employee benefit plans. There are too many to describe in the context of this brief statement, and our submission of August 1985 will have to serve that purpose.

Comment.--We wish to leave the Committee with one thought: namely, that employee benefit plans are a vehicle for much of the savings that is done in the United States. Those savings find their way into business investment. If capital formation is of concern to the Committee, we believe that all proposals impacting adversely on savings should be reevaluated in light of the entire bill with its seriously anti-savings bias. In addition, as we noted in our earlier statement, a number of the provisions basically change the rules in mid-course and lack equity to potentially affected parties. Although we do not support those existing rules of law that may countenance discrimination on the part of the affluent at the expense of taxpayers who are less fortunate, we also believe that very successful savings vehicles like cash-or-deferred-arrangements should be treated "gingerly"--if not deferentially--because of their boost to savings and the role they play in helping persons to provide for themselves in time of need, including retirement.

It is remarkable that so much negative "reform" effort would be expended in an area that is so sensitive from human relations, fairness, retirement policy, and savings standpoints. We urge thorough reconsideration beginning with a "clean slate," and ask that nothing along these lines in H.R. 3838 be taken for granted.

Concluding Comment

We do not relish the Committee its task of ruling on the merits of "tax reform" ideas that seem to pander to the perceived self-interest of much of the electorate at the expense of vital parts of the business community and, indeed, the national interest. As we witnessed the eleventh-hour struggle in the House of Representatives--a struggle that narrowly and conditionally saved H.R. 3838 from ignominious defeat--the disheartening message of the proponents seemed to be that "true loyalists" do not desert, whether the course of action of the moment is correct or not. Now the responsibility lies with the Committee to restore balance to the project or to abandon it altogether in response to the press of more important business. In the nature of the institution, the Senate is more capable than the House of dispassionate, statesmanlike inquiry. Accordingly, we have high expectations as the Committee embarks on its mission.

Finally, we hope that the Committee members will agree with us that the Code may need a "face-lift" but not the disfigurement embodied in H.R. 3838. Moreover, whatever surgical procedure is employed, it should be based on sound tax and economic policy rather than a relentless search for tax revenues to pay for a preconceived sudden and arbitrary reduction in rates.

MAPI appreciates having the opportunity to present its views to the Committee on this matter of mutual interest.

THE MAINE MANUFACTURING COMPANY • [illegible] • ENGINEERING • MANUFACTURE
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603 882-5142

February 13, 1986

The Honorable Robert Packwood
Chairman
Senate Committee on Finance
219 Russell State Office Building
Washington, D.C. 20510

Attention: Ms. Betty Scott-Boom

Dear Ms. Scott-Boom:

I am writing to express my opposition to HR 3838, the Tax Reform Act of 1985.

A critical goal is to reduce the Federal deficit and in the long run this can be accomplished only by shifting personal income dependence from the public sector to the private sector.

Expanded private sector employment is dependent upon capital formation, improved competitiveness, and a growth economy. HR 3838 is counter-productive to attaining these goals and I encourage your opposition to this legislation.

Sincerely,

Alfred M. Norton, Jr.
Chairman

AMN:fes

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CCF #86020527

STATE OF MARYLAND
STATE BOARD FOR HIGHER EDUCATION

CHAIRMAN
Richard R. Kline

COMMISSIONER OF
HIGHER EDUCATION
Sheldon H. Knorr

The Jeffrey Building
16 Francis Street
Annapolis, Maryland 21401
(301) [illegible]

February 18, 1986

Senate Finance Committee
   c/o Betty Scott-Boom
Committee on Finance
Room SD 219
Senate Dirksen Office Building
Washington, D.C.   20510

Dear Senate Finance Committee Members:

I am writing in opposition to HR 3838 which proposes to tax the pension plan funds held by Teachers Insurance and Annuity Association-College Retirement Equities Fund (TIAA-CREF). This proposal would treat higher education's pension system unfairly and would reduce participants' pension benefits.

Mr. James MacDonald of TIAA-CREF has testified before you; I am in support of his position.

Sincerely,

Sheldon H. Knorr
Sheldon H. Knorr
Commissioner

SHK:mr

cc: Mr. James MacDonald

M

DEPARTMENT OF HUMAN RESOURCES

HARRY HUGHES
Governor

TELEPHONE

Office of the Secretary

RUTH MASSINGA
Secretary

JAMES TRAGLIA
Deputy Secretary

WRITTEN TESTIMONY OF RUTH MASSINGA

SECRETARY, MARYLAND DEPARTMENT OF HUMAN RESOURCES

TAX REFORM AND THE POOR

FEBRUARY 14, 1986

SUBMITTED TO THE SENATE
FINANCE COMMITTEE

1100 North Eutaw Street　Baltimore, Maryland 21201　TTY: 383-6994

TAX REFORM AND THE POOR

I WOULD LIKE TO THANK THE SENATE FINANCE COMMITTEE FOR ALLOWING ME THE OPPORTUNITY TO SUBMIT TESTIMONY ON THE IMPACT OF TAX REFORM ON THE POOR. AS THE CHIEF EXECUTIVE FOR HUMAN SERVICES IN THE STATE OF MARYLAND, I CANNOT OVERSTATE THE NEED AT THIS TIME FOR LEGISLATION THAT SEEKS TO ALLEVIATE THE INEQUITABLE TAX BURDEN THAT HAS BEEN PLACED ON THE POOR. WHILE TAXATION OF THE POOR HAS INCREASED NEARLY FIVEFOLD SINCE 1979, THE TAX RESPONSIBILITY OF WEALTHY INDIVIDUALS AND CORPORATIONS HAS DECREASED. IT IS A NATIONAL TRAGEDY THAT THE VERY AMERICANS WHO HAVE FACED UNPRECEDENTED PROGRAM REDUCTIONS OVER THE PAST FIVE YEARS SHOULD BE THE SAME MEMBERS OF OUR SOCIETY WHO CARRY A DISPROPORTIONATE SHARE OF THE TAX LIABILITY. TAX REFORM IS CERTAINLY ONE OF THE MOST IMPORTANT ISSUES THAT CONGRESS WILL TAKE UP IN THIS SECOND SESSION; FOR THE POOR AND NEAR POOR, TAX REFORM IS CRUCIAL FOR THEIR SURVIVAL.

IN RECENT YEARS WE HAVE WITNESSED IN AMERICA AN INCREASING NUMBER OF PEOPLE LIVING IN POVERTY. IN FACT, THE NUMBER OF THOSE LIVING BELOW THE POVERTY LINE HAS SWELLED BY SIX MILLION SINCE 1980, WITH NEARLY HALF OF ALL FEMALE-HEADED FAMILIES WITH CHILDREN BEING IMPOVERISHED. ALMOST 35 MILLION AMERICANS NOW LIVE AT A LEVEL WHICH THE FEDERAL GOVERNMENT CONCEDES, BY ITS OWN DEFINITION, IS NOT ENOUGH TO EXIST ON. THESE STATISTICS ILLUSTRATE THAT THE DREAM OF ERADICATING POVERTY IN OUR COUNTRY HAS BECOME A DREAM THAT FOR MANY HAS NO HOPE OF EVER BEING REALIZED.

IT MAY SHOCK SOME TO KNOW THAT THE MAJORITY OF POOR FAMILIES TODAY ARE EMPLOYED. YET, ALMOST HALF OF ALL INDIVIDUALS AND FAMILIES BELOW THE POVERTY LINE, WHICH WAS ONCE CONSIDERED THE LEVEL AT WHICH INDIVIDUALS DID NOT HAVE TO PAY TAXES, ARE SUBJECT TO FEDERAL TAXATION. THIS HAS OCCURRED IN PART BECAUSE THE INCOME TAX THRESHOLD HAS CONTINUED TO DIP FARTHER AND FARTHER BELOW THE POVERTY LINE, CAUSING THE NUMBER OF HOUSEHOLDS LIVING IN POVERTY TO MORE THAN TRIPLE SINCE 1979. PAYROLL AND INCOME TAXES THAT WERE PAID BY POOR FAMILIES INCREASED BY AS MUCH AS 58% BETWEEN 1980 AND 1982 ALONE. AS A PERCENTAGE OF FAMILY INCOME, A TWO PARENT WORKING FAMILY OF FOUR WOULD HAVE PAID ONLY 1.9% OF ITS INCOME IN TAXES IN 1979. BUT THAT FAMILY IN 1985, EARNING POVERTY LEVEL WAGES, PAID 10.4% OF ITS INCOME IN FEDERAL TAXES. FOR A SINGLE PARENT FAMILY WITH THREE CHILDREN, THE TAX BURDEN IS EVEN GREATER THAN THAT OF THE TWO PARENT WORKING FAMILY. THESE VERY SAME FAMILIES THAT IN THE PAST FEW YEARS HAVE BEEN SUBJECTED TO INCREASING FEDERAL TAXES ARE THE SAME FAMILIES THAT ARE BEING FORCED INTO DEPENDENCY ON FEDERAL AID PROGRAMS FOR THE POOR. WHAT WE ARE LEFT WITH IS A SITUATION WHERE A POOR FAMILY IS PAYING TAXES IN ORDER TO HELP SUPPORT LOW INCOME PROGRAMS FROM WHICH THEY WILL EVENTUALLY BE RECEIVING SERVICES.

FOR FAMILIES JUST ABOVE THE POVERTY LEVEL, THE PREDICAMENT IS EQUALLYAS GRAVE. THOSE FAMILIES FACE AN EVER INCREASING TAX BURDEN THAT MAY EVENTUALLY PULL THEM DOWN DEEPER INTO POVERTY WITH LITTLE HOPE OF ESCAPE. IN THE LATTER PART OF THE 1970'S, THE TAX THRESHOLD FOR A TWO PARENT FAMILY OF FOUR WAS ABOUT 18% ABOVE THE POVERTY LINE. IN 1987, UNDER CURRENT LAW, THAT FAMILY WOULD BEGIN TO OWE TAXES AT A LEVEL 20% BELOW THE POVERTY LINE.

THE PRESIDENT, IN HIS RECENT STATE OF THE UNION ADDRESS, STRESSED THE NEED FOR THOSE WHO RECEIVE PUBLIC ASSISTANCE THROUGH LOW INCOME PROGRAMS TO BE HELPED INTO SELF-SUPPORT. IN MARYLAND, IT IS THE GOAL OF MY DEPARTMENT TO ADMINISTER PROGRAMS THAT HELP THOSE IN NEED AND ASSIST AS MANY AS ARE ABLE TO BECOME SELF-SUFFICIENT. YET, LOSS OF INCOME FOR THE POOR THROUGH TAXATION HAS MEANT ONLY A GREATER DEPENDENCE ON SOCIAL PROGRAMS. THIS FRUSTRATES THE EFFORTS OF STATE AGENCIES WHICH ADMINISTER TO THE POOR. WE CAN PROVIDE NECESSARY SERVICES AND HELP THE CLIENT FIND SUSTAINED EMPLOYMENT, BUT UNDER THIS SYSTEM OF TAXATION THAT CLIENT AND HIS FAMILY WILL CONTINUE TO LOSE GROUND IN THEIR FIGHT TO GET OUT OF POVERTY.

THE HOUSE PASSED BILL ON TAX REFORM, H.R. 3838, GOES A LONG WAY TOWARD ESTABLISHING A MORE EQUITABLE TAX SYSTEM, THEREBY PROVIDING ENHANCED OPPORTUNITIES FOR THE POOR. H.R. 3838 REDUCES THE TAX BURDEN ON THOSE IN POVERTY PRIMARILY THROUGH THREE MAJOR CHANGES IN THE TAX CODE: THE STANDARD DEDUCTION, THE PERSONAL EXEMPTION AND THE EARNED INCOME TAX CREDIT(EITC). IN RECENT YEARS, THESE THREE KEY FEATURES HAVE ERODED AWAY THROUGH INFLATION. THE BILL MAKES THE NECESSARY ADJUSTMENTS IN THESE FEATURES BY NEARLY DOUBLING THE PERSONAL EXEMPTION, SIGNIFICANTLY INCREASING THE STANDARD DEDUCTION BY ALMOST $1,000,AND EXPANDING AND INDEXING THE EITC. BY REFORMING THESE INDIVIDUAL PROVISIONS THAT MAKE UP THE TAX THRESHOLD, BOTH TWO PARENT AND SINGLE PARENT HOUSEHOLDS WILL BE PROTECTED FROM PAYING A DISPROPORTIONATE SHARE OF TAXES NOW AND IN THE FUTURE.

THREE ADDITIONALLY IMPORTANT ISSUES REGARDING TAX REFORM LEGISLATION INCLUDE: MAINTAINING THE CHILD CARE TAX CREDIT, WHICH GIVES POOR FAMILIES, ESPECIALLY SINGLE-PARENT FAMILIES, THE FREEDOM TO SEEK AND ENGAGE IN EMPLOYMENT THAT MAY LEAD TO SELF-SUFFICIENCY; RETAINING THE DEDUCTABILITY OF STATE AND LOCAL TAXES, WHICH IF REMOVED MIGHT CAUSE STATES TO REDUCE THEIR TAX RATE, THEREBY FORCING AN ELIMINATION OR REDUCTION OF SOME STATE AND LOCAL SERVICES; AND EXEMPTING FROM TAXATION A PORTION OF THOSE EMPLOYER PROVIDED BENEFITS, WHICH HAVE BEEN SHOWN TO HAVE A PROPORTIONATELY GREATER BENEFIT FOR LOW AND MODERATE INCOME WORKERS.

THE HOUSE, IN PASSING H.R. 3838, HAS ACKNOWLEDGED THE INEQUITABLE TAX BURDEN THAT HAS BEEN PLACED ON THE POOR OF OUR SOCIETY AND HAS SOUGHT TO CORRECT THAT FROM HAPPENING IN THE FUTURE. ALTHOUGH THERE STILL REMAIN SOME CONCERNS THAT WERE NOT ADDRESSED IN THE BILL, SUCH AS ITS TREATMENT OF LOW INCOME HOUSING AND ADJUSTING THE EITC TO INCLUDE LARGE FAMILIES AT THE POVERTY LEVEL, H.R. 3838 IS SUBSTANTIALLY MORE BENEFICIAL TO THE POOR THAN THE CURRENT TAX LAW. IN FACT, AS PRESENTLY WRITTEN H.R. 3838 WOULD REMOVE OVER SIX MILLION POOR AND NEAR POOR TAXPAYERS FROM THE INCOME TAX ROLLS, WHILE PROVIDING ALMOST $30 BILLION IN TAX RELIEF OVER THE NEXT FIVE YEARS TO TAXPAYERS WITH INCOMES OF LESS THAN $20,000. I, THEREFORE, ENCOURAGE THE COMMITTEE TO SUPPORT THE PROVISIONS CONTAINED IN H.R. 3838 THAT BENEFIT THE POOR.

M

7100 MUIRKIRK ROAD, BELTSVILLE, MARYLAND 20705

MARYLAND
CLAY PRODUCTS

February 13, 1986

Becky Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Building
Washington, D. C. 20510

Dear Senator Packwood:

It is my understanding that your committee will be considering Tax Reform Bill HR3838 in the near future, if it has not already begun to do so.

The House passed Bill does nothing to address two very serious problems which the Nation faces. The two monstrous deficits faced by the Nation in its national budget and in the area of foreign trade, are not addressed by this Bill and will be worsened by this Bill. Tax incentives allowed to business in the 1981 Economic Recovery Act will be diminished. The Nation's manufacturing plant needs every incentive to enhance its ability to compete in the international trade arena. Tax incentives need to continue in order that plant and equipment may be upgraded so that manufacturing costs can be contained or reduced so that we may compete.

Because of incentives made available in the 1981 Economic Recovery Act, this Company was able to justify the expenditure of well over a million dollars in order to convert from natural gas to a waste product for our primary fuel source. This can help contain the cost of our products and the tax incentives will help make American manufacturing industry more competitive. Creation of use for a waste product and reduction in demand on non renewable resources is certainly a step in the right direction.

PHONES: WASHINGTON, D.C. 953-2214 (Area Code 301) BALTIMORE, MD. 792-0444 (Area Code 301)

It appears that House Bill HR3838 has very little merit and should probably be set aside until spending and trade deficits are curbed. I shall appreciate your including these comments in your hearing record and will appreciate your consideration on these thoughts.

Sincerely yours,

MARYLAND CLAY PRODUCTS, INC.

Hunt Archer

Hunt Archer
President

HA:MH
CC: Senator Charles McC. Mathias, Jr.
Senator Paul S. Sarbanes

M

Marlin
INDUSTRIES

January 23, 1986

Betty-Scott-Boom
Committee on Finance
Room SD-219
Dinkson Senate Office Building
Washington, D.C. 20510

RE: **Economic Effects of H.R. 3838 on International Competitiveness and Capital Formation**

The U.S. House of Representatives has passed H.R. 3838, the Tax Reform Act of 1985, which would make sweeping changes on the taxation of corporations, individuals, estates and trusts. Several of those changes would drastically effect capital formation, and international competitiveness. Passage of this bill by the Senate would have a significant impact on capital formation and competitiveness. Those changes that would result would be as follows:

1) The reduction of depreciation would greatly effect real estate and result in a decrease in both construction acquisition and development of real estate. The House Bill will replace the Accelerated Cost Recovery System (ACRS) with a new "incentive depreciation" system which is generally less favorable than current law. Personal and real property will be categorized into 10 classifications based on asset depreciation range (ADR) mid-point lives, with recovery periods ranging from 3 to 30 years. The significant classifications impacting the real estate industry and the methods of depreciation which will be allowed are as follows:

a) Depreciation on 19 year ACRS real property would be reduced from 175 percent declining balance over 19 years to straight-line over 30 years. Thus, the net present value of depreciation deductions for 19 years ACRS real property will be reduced by approximately 36.7 (assumes 10 percent discount factor and no inflation adjustments).

b) Low-income housing will be depreciated over either 20 or 30 years rather than the current ACRS period of 15 years. A 20 year useful life will be allowed for "very" low income housing while a 30 year life will be required for "moderate" low-income housing. The 200 percent declining balance depreciation method will be retained for low-income housing.

8601 Wilshire Blvd., Suite 1100, Beverly Hills, California 90211 • (213) 276-5448 • 1-800-325-5991 (Calif.) • 1-800-325-7183 (Nat'l)

c) Personal property is generally classified as 3 year property (e.g., cars and trucks) or 5 year property (e.g., machinery and equipment) under current law. Under the House bill, personal property and land improvements used in real estate activities will generally be classified as follows:

Class	Description	Period
2	Computer equipment, cars and light trucks	5
4	Office furniture and fixtures	10
7	Land improvements	20

The 200 percent declining balance method, with a conversion to straight-line, will be allowed for all classifications, with the exception of real property. Alternatively, a straight-line method of depreciation, with recovery periods based on ADR class lives, may be elected.

The House bill provisions will generally be effective for property placed in service after 1985. However, the bill provides transitional rules whereby property placed in service after 1985 may qualify under current law if certain tests were met on September 25, 1985. These changes in the depreciation schedules will reduce both investment and development of real estate, which will increase rents:

Under the House bill, a 36 percent rate would apply to corporate capital gains generated after 1985. The 28 percent alternative capital gains tax allowed under current law will apply only to net capital gains for which a binding contract was in effect on or before September 25, 1985. Thus, for example, the 28 percent preferential tax rate will be available for all capital gains generated on an instalment sale made prior to September 25, 1985. Although the bill eliminates the corporate "alternative" capital gains tax, it does not change the treatment of net capital losses.

For individuals, the House bill increases the maximum effective tax rate on net capital gains from 20 percent to 22 percent. In addition, capital gains will continue to be a tax preference for individuals' alternative minimum tax calculations.

Current law permits corporations who engage in long-term contracts to defer income recognition until the contract is completed (referred to as the completed contract method). The House bill requires gross income from long-term contracts entered into after September 25, 1985, to be recognized under the percentage of completion method. The amount of gross income recognized in a particular year is determined by multiplying revenues by the percentage of costs incurred during the year over total estimated costs of the contract.

After the contract has been completed and actual revenue and cost data are known, the taxpayer will recompute the correct income inclusion for each year of the contract. Interest will then be calculated and payment made or refund applied for on any underpayment or overpayment of tax. These changes will complicate the income allocation of contrast revenue.

The House bill modifies the definition of long term contract to require contract periods of one year or longer. Further, two or more contracts that are interdependent are considered one contract.

If a contractor qualifies for the completed contract method, the income deferred would be a tax preference for purposes of the minimum tax computation. The tax preference will only apply to contracts entered into after September 25, 1985.

In addition to the above changes in the completed contract method, comprehensive capitalization rules would be implemented by the House bill. Most notably, construction period interest would be included in depreciable basis and be depreciated over thirty years rather than the current law amortization period of ten years.

Under current law, real estate activities are excluded from the at-risk rules. The House bill extends the at-risk rules to real estate, except taxpayers would be considered to be at-risk for "qualified nonrecourse financing" (generally defined as a loan from an independent third party in the business of making loans). Thus, seller financing, which includes wrap-around debt and purchase money debt, will not qualify. The exception for "qualified nonrecourse financing" is a significant concession the real estate industry obtained during negotiations in the House Ways and Means Committee. The adoption of the at risk rules would all but eliminate seller financing, decrease real estate sales and purchases and slow real estate activity entirely.

The House bill would generally make it more difficult to deduct nonbusiness interest. Under current law, individuals may deduct investment interest expense up to the sum of $10,000 ($5,000 for married filing separately) plus net investment income plus out of pocket expenses on net leased property. The bill broadens the definition of interest expense and changes the limitation. Interest subject to the limitation would no include all personal interest (except for interest on a taxpayer's principal residence and one other residence) and interest attributable to a limited partnership interest where the general partner does not participate in management). The bill also changes the limitation to $20,000 ($10,000 for single taxpayers) plus net investment income plus out-of-pocket expense on net leased property.

The House bill will change the calculation of net investment income. Two of the more significant changes are: 1) Include income or loss from limited business interests. 2) Actual depreciation would be used in calculating investment expense.

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The changes to nonbusiness interest in the House bill will generally be phased in over a ten year period.

The House bill eliminates the ITC for property placed in service after 1985. However, transitional rules similar to those for depreciation would apply. If property qualifies under the transitional rules, the ITC will be spread over five years and the property's basis will be reduced by the full ITC. Thus, ITC on tangible personal property and elevators will generally not be available after 1985.

By eliminating ITC, capital formation and retooling of industries, plants and equipment will be significantly reduced. The modernization effort of many industries would be brought to a halt.

The House bill reduced the credit as follows (subject to some very limited transitional rules) for property placed in service after December 31, 1985:

Current law	House bill
Property qualifying for 15 percent and 20 percent credits	10 percent credit if building was placed in service prior to 1936
Certified historic structures - 25 percent with 50 percent basis reduction	20 percent credit and full basis reduction

The House bill will maintain five year amortization of expenditures to rehabilitate low-income housing. However, the general $20,000 per unit limitation would be increased to $30,000. The $40,000 maximum which applied in certain cases under current law would be eliminated.

By reducing the tax credits for the restoration of historical property, there will be a slow down in the revitalization of our urban area and in our historical properties.

The House bill would preserve the tax-exempt status of bonds for multifamily housing, mortgage subsidy bonds, and mortgage credit certificates, but they would be subject to greater restrictions. These restrictions will significantly curtail tax-exempt financing and reduce the availability of the funds.

Under current law, taxpayers have entered into instalment sales and have pledged the instalment receivable as collateral for loans. Thus, taxpayers have effectively converted the instalment receivable to cash but have not had to recognize the deferred gain. Several builders have used this technique by selling houses on the instalment method and then contributing the instalment receivables to subsidiary which would issue "builder bonds" (i.e., bonds backed by the mortgage contributed to the subsidiary).

The House bill will eliminate the above techniques by generally requiring taxpayers to recognize taxable income when instalment receivables are pledged for a loan. Certain pledges are excluded under the House bill. These provisions will generally be effective for any pledge of instalment receivables after December 31, 1985. However, instalment receivables arising after September 25, 1985 that are pledged before January 1, 1986 will be treated as pledged on Janaury 1, 1986 if still outstanding on that date.

The enactment of H.R. 3838 would have an overall chilling effect on the recovery of the economy. At a time when the major concern should be deficit reductions a tax bill like H.R. 3838 would have a negative impact on the goals of deficit reduction and on the recovery of the economy.

We urge the Senate not to pass H.R. 3838 or any version of it which will result in both a slowing down of our economic recovery, or a curtailment of capital formation. The concept of tax simplication is a sound one. However, H.R. 3838 does not simplify the current tax code, but merely eliminates incentives which have been and continue to be necessary to our economic growth.

Very truly yours,

MARLIN INDUSTRIES

Mark Anderson
President

MA/mmc

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NEEDED TAX AMENDMENTS TO PRESERVE THE FAMILY AND TO PROMOTE ECONOMIC GROWTH

SUBMITTED BY

JOHN C. Mc LANE

BEFORE THE SENATE COMMITTEE ON FINANCE

U.S. SENATE

SENATE DIRKSON BUILDING, ROOM 219

WASHINGTON , D.C. 20510

FEBRUARY 3, 1986

Needed Tax Amendments to Preserve the Family & to Promote Economic Growth

President Reagan's tax proposal and the United State (U. S.) House Representative tax bill need amendments. Presently, the Internal Revenue Service (IRS) tax code, President Reagan's tax proposal, and the U. S. House tax bill penalize marriage, reward debt financing over equity financing (an act that contributes to higher interest rates), fail to grant economic development bonds to rural America's capital investments, reward American firms who do business with adversarial governments, subsidize high tax states at the expense of low tax states, and subsidize political campaigns. Tax policy must strenthen the family and spur economic growth.

The Senate Finance Committee must adopt the following amendments to strengthen the family and spur economic growth. They are:

(1) Set the standard deduction per person at $1,800. This act will produce $45,200 Million (M) more taxable income than President Reagan's tax proposal of $2,000 per person ($452,000 M exempt taxable income, 226 M people times $2,000, less $406,800 M., 226 M people times. $1,800). This $45,200 M taxable income produces a tax revenue range from $6,780 M ($45,200 M x .15 tax rate) to $15,820 M ($45,200 M x .35 tax rate).

However, this act produces a range of $11,300 less taxable income to $11,300 taxable income than the U. S. House tax bill. To explicate: if 50% of the taxpayers are itemizers and 50% are nonitemizers, the House tax bill produces $395,500 M of exempt taxable income (.5 x 226 M x $2,000 + .5 x 226 M x $1,500). If 70% of the taxpayers are nonitemizers and 30% are itemizers, the House tax bill produces $418,100 M of exempt taxable income (.7 x 226 M x $2,000 + .3 x 226 M x $1,500). By subtracting $395,500 M exempt taxable income of the U. S. House from $406,800 exempt taxable income, there is a $11,300 M deficit of taxable income. By subtracting $406,800 M exempt taxable income from $418,100 M exempt taxable income of the U. S. House, there is a $11,300 M surplus of taxable income. As the nonitemize taxpayers rate increases beyond 60%, there is more taxable income. In contrast, as the nonitemize taxpayers rate decreases below 60%, there is less taxable income. The $11,300 M deficit of taxable income and the $11,300 M surplus of taxable income produce a deficit range and a surplus range of $1,695 M ($11,300 x .15 tax rate) to to $3,955 M ($11,300 x .35 tax rate).

(2) To mitigate the marriage penalty tax, set the zero bracket amount for people filing singly at $2,500 and for people filing married jointly at $5,000 if each spouse earns over $4,300, the sum of the $2,500 zero bracket amount plus the $1,800 standard deduction amount.

Also, set the ranges of the tax brackets of the married filing jointly to equal twice the ranges of the person filing singly. To show: If the top 15% tax rate amount is $20,000 for a person filing singly, the maximum 15% amount for the person filing married jointly is $40,000. This act will reduce the marriage penalty tax of increased tax rates. However, the marriage penalty tax is purely eliminated when there is a flat tax rate.

For those working married couples where at least one spouse earns less than $4,000 or only one spouse earns any amount of money, there is a $4,000 zero bracket amount.

However, for those married couples filing married jointly where one or both spouses earn individually between $4,000, inclusive, to $4,300, inclusive, a 10% tax credit of the difference between the amount earned up to $4,300 less $4,000 per spouse is granted. To illustrate: Both spouses earn $4,300 each; each spouse gets a 10% tax credit of $30, .1($4,300 - $4,000). Thus, the married working couple filing jointly gets a $60 credit. Thus, the marriage penalty tax of $150, .15 tax rate times the difference of $5,000 less $4,000, is reduced by $60 to $90.00. Next, at a 35% tax rate, the marriage penalty tax before credit is $350.00, .35($5,000 - $4,000). By subtracting $60.00 tax credit from $350.00, the net marriage penalty tax is $290.00. Therefore, the lower income tax rate couples get the greater percentage benefit.

(3) Next, the Senate Finance Committee must reward equity financing over debt financing, an act that will reduce the demand for borrowed funds at that level of interest rate. The accelerated depreciation needs amending. Curtail accelerated depreciation for plant, equipment, and buildings for only debt financing. However, maintain accelerated depreciation at the present capital cost recovery schedules for equity financing. For a company that uses

debt financing, it can use only straight line depreciation and use only 50% of the interest expense as a deduction for computing taxable income. The difference between the amount of accelerated depreciation and straight line depreciation results in an indefinite carryforward. For a firm who uses a combination of debt and equity financing, it uses only the equity percentage at its rate times the amount of accelerated depreciation. The nondeductible accelerated depreciation is deferred as an indefinite carryforward. The firm utilizes the deferred accelerated depreciation after the allowed depreciation expense is completely utilized.

To illustrate: A $9,000 machine with a nine year life is depreciated over three years for acceleration. The accelerated amount is $3,000 ($9,000/3 years); the straight line amount is $1,000 ($9,000/9 years). For equity financing of 100%, all $3,000 is deductible; for debt financing of 100%, only $1,000 is deductible with $2,000 as an indefinite carryforward; for equity financing of 50%, only $2,000 ($1,000 + 50% of the quantity of $3,000 - $1,000) is deductible with only $1,000 as an indefinite carryforward. To further explicate, in the fifth year in 100% debt financing, the firm pays the debt so that it could get the full $3,000 accelerated depreciation expense on top of the accumulated $4,000 straight line depreciation. For the next year the firm depreciates the $2,000 carryforward.

Moving on, the U. S. House tax bill needs amending on intangible drilling costs and on percentage depletion allowance. When using debt financing, curtail intangible drilling cost writeoffs and the percentage depletion allowance. For companies that use debt financing, they must amortize their intangible drilling cost over the life of the asset at a straight line rate as well as use zero percentage depletion allowance. Also, only 50% of the interest expense is deductible for computing taxable income. The unused writeoffs of intangible drilling costs and the unused percentage depletion allowance are deferred as an indefinite carryforward. For firms that use equity financing, they would writeoff all the intangible drilling costs in the year incurred and use a 15% percentage allowance rate. For companies that use a combination of debt and equity financing, they would use the equity percentage at its rate times the intangible drilling costs and times the 15% depletion rate. The firms use the deferred intangible drilling costs and the deferred percentage depletion allowance after completely using the allowed amortization of intangible drilling costs and the percentage depletion allowance.

To illustrate: A company incurs $1,000 M in drilling costs with a ten year life and 500,000 gallons of oil selling at $1.00/gallon. For debt financing the firm deducts $100,000 in intangible drilling costs ($1,000 M/10 years) with $900,000 as an indefinite carryforward and deducts zero for percentage depletion allowance with a $75,000 indefinite carryforward (500,000 gallons x $1/gal. x 15%). For equity financing the firm writes off $1,000 M in intangible drilling costs and $75,000 in percentage depletion allowance. For using 50% equity financing, a firm gets $500,000 in intangible drillings costs (.5 x $1,000 M) with $500,000 as an indefinite carryforward and gets $37,500 in percentage depletion allowance (500,000 gallons x $1/gallon x 15% x 50%) with $37,500 as an indefinite carryforward.

The reasons for adopting these amendments for the disincentives of debt financing and the incentives for equity financing are lower interest rates; lower government interest expense; continuation of the modernization of plant, machinery, equipment, and buildings; and the acceleration of the exploration and production of our natural resources. According to Paul Meek of the Federal Reserve Bank of New York, businesses get presently 60% of their cash from non cash expenses and retained earnings. With lower tax rates and the continuation of accelerated depreciation and percentage depletion allowance, the percentage of self generated cash will increase. Thus, there is less amount of money to be borrowed by each company. (An appenappendix is attached to show how lower interest rates occur).

(4) The U. S. House tax bill needs an amendment to restore economic development bonds (sometimes called industrial revenue bonds) for capital costs for urban firms. Also, another amendment to grant economic development bonds for the capital costs of rural business is needed. Urban

businesses and rural businesses should be able to borrow money at 60% to 80% of the prime rate of interest. This subsidy generates more tax revenue because it generaates new businesses and jobs. The lower interest expense of the borrowers permits the borrowers to pay more income taxes while the lower interest income of the lenders produces lower income taxes for the lenders. Thus, there is nearly a washout of the change to lower income for the borrowers and of the change to higher income for the lenders.

(5) Moving on, an amendment to terminate the present tax policy of permitting American firms to get 100% deductions for business expenses incurred in adversarial nations and for payments to adversarial governments for the right to conduct business in those nations. Presently, Gulf Oil is financing the Marxist Government of Angola. Also, Occidental Petroleum Company paid a royalty expense to Libya and incurred other business expenses in Libya. All of these expenses are tax deductible. The idea of American companies getting tax deductions for financing adversarial governments to export terrorism or totalitarian revolutions to other nations is repugnant. If these companies want to finance Marxist governments who export revolution or terrorist states, let them do it without getting tax deductions.

(6) Moving on, terminate the tax deductibility for

state and local governments. The deductibility of state and local taxes rewards those people in high tax states and penalizes those people in low tax states. Also, this tax deductibility encourages states and localities to continue their wasteful spending. In contrast, the termination of the deductibility forces states and localities to practice economic efficiency.

(7) Finally, terminate tax credits for politcal contributions. These tax credits produce minimal to zero economic growth.

With all of these amendments, the family unit is strengthen and the economy will grow at a faster pace. The choice for tax reform that promotes the unity of the family and robust economic growth or one that supports the disintergration of the family and minimal economic growth is yours to make. What will it be?

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There is no question that foreign competition in the automotive industry is stiff. To meet this competition U.S. companies must continuously improve the quality and performance of their products and increase productive efficiencies. Capital available for investment in improved plant and equipment is certainly essential, but there is a second and complementary need -- funds for research and development. In the view of the MVMA, none of the testimony offered at the recent hearings placed sufficient emphasis on the critical connection between funding for applied research and development and the availability of capital investment levels sufficient to maintain international competitiveness. Few witnesses even mentioned research and development or explained the relationship of new technologies to capital formation. Achieving competitive products through improved products requires compatible levels of research and development and manufacturing processes.

Particularly important in an economy the size and complexity of ours is applied research and development. Enormous economic and technical risks are involved in translating basic research gains into less expensive, new, and improved products, as well as productive new manufacturing techniques, processes and equipment. Applied research and development is the critical nexus between basic research and commercial production. Our principal foreign competitors in Japan and Western Europe have long recognized this critical connection, and their governments generally provide substantial support to their research activities. In the U.S., this has not generally been the case.

In the automotive industry, in particular, innovative engineering and new technology have substantially accelerated the evolution of both automotive products and production methods. The resulting advances have stimulated substantial domestic capital investment by the U.S. automotive companies, with correlative beneficial economic influences throughout our economy. Unless this level of investment continues, U.S. manufacturers will be unable to keep pace with foreign competitors and their new automotive products.

In summary, both applied research and development and capital formation are important to international competitiveness. Neither should be discouraged by the comprehensive tax reform package that is currently pending before the Senate Finance Committee.

Sincerely,

John S. Nolan
Phillip L. Mann
F. Brook Voght

By Phillip L. Mann

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February 10, 1986

Senator Bob Packwood
259 Senate Russell Office Bldg.
Washington, D.C. 20510

Re: Tax Reform Hearings

Dear Senator Packwood:

Enclosed please find for your review a copy of an essay on HR 3838 which I am submitting to the record of the Finance Committee hearings on tax reform. I hope you find the enclosed to be persuasive arguments against the Bill, and I welcome the opportunity to discuss my views with you or your legislative aides at any time.

With every good wish, I remain,

Very truly yours,

Kenneth J. Fleisher, Esq.
Melvin B. Miller, Ltd.

enc.
KJF:asb

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from Philadelphia Business Journal
February 10-16, 1986

Commentary

President Reagan's tax plan has 'gone awry'

By JONATHAN BUTCHER
Chairman
Butcher and Co. Inc.

Annuit coeptis — He favorable to bold enterprises. Benjamin Franklin's choice for the inscription on the back of our dollar bill was based on the belief that new ventures were the basis of the emerging American economy.

The "spirit of enterprise" may be an overused term now, but the founders believed in it, and they encouraged it. The new empire was built by people who were willing to take risks of all sorts: in ways of thinking, in ways of doing business, in ways of organizing a polity. The risks were great, but as our history attests, the rewards were greater.

As a businessman, I don't spend much time thinking about our founding fathers and national heritage and principles. I spend most of my time dealing with what I consider to be "bold enterprises" — my entrepreneurial interests in real estate, banking, energy exploration, venture capital, equipment leasing, traditional stock brokerage and corporate finance. But I've been spending a lot of time thinking about another bold enterprise: the effort to reform the tax system.

Initially, I praised the stated goals of tax reform: to simplify and make more equitable a needlessly complex and arbitrary system, and to encourage economic growth by unfettering businesses and individuals to pursue wealth. Initially, I had thought the champion of tax reform was the Ronald Reagan I had helped elect in 1980 and again in 1984. Reagan seemed to be the first national leader in recent memory to understand the importance of entrepreneurship, of new ventures and of small businesses in fueling our economy. To Reagan, profit was not a dirty word. The tax policies he unveiled in 1981 were very bold; he called them "revolutionary." But now Reagan's bold enterprise has gone awry — to the potential detriment of individuals and businesses, entrepreneurs and investors. The tax reform proposals of the administration and of Congress not only contravene the principles of the Reagan revolution, they also undermine the proven bases of capital formation and economic growth in this country.

Jonathan Butcher

From my vantage point as a real world decision maker — as an entrepreneur who has started businesses of my own and contributed to businesses started by others, I know, without a doubt, that the tax changes of 1981 enhanced my ability to do business and to start businesses.

I've also contributed to the intended public policy effect. I've helped create new businesses, new jobs and new taxable income. I am convinced that the tax proposals being debated in Congress will severely compromise my ability to contribute to these public purposes.

Granted, my purpose as a businessman is not to satisfy public policy objectives. My goal is to make money, both for my clients and myself. The policy-makers on Capitol Hill are presumably concerned with the public policy objectives. But the reality is that the impact of fiscal policy depends on the business decisions made by people like me, multiplied by the hundreds of thousands. My concern is that our policy-makers do not understand what factors guide business decision-making.

One of the most basic equations in making a business decision is the risk/reward ratio. I will enter into a risky venture if the potential reward is great enough.

My investment decision is based on whether a project makes business sense, not social sense. Under the tax reform proposal advanced by President Reagan, it would no longer make financial sense for me to risk getting involved in many urban projects. For the rate of return that would be allowed under the Reagan plan, I might as well put my money in Treasury bills or municipal bonds, where I have a considerably greater chance of seeing the returns. If the rehabilitation tax credit is abolished, I lose as a real estate developer; and cities lose, because no one in the private sector is going to replace me and the work I do. And, I submit, most city governments cannot afford to take over where private builders are forced to leave off.

Similarly, cities would lose out if private-purpose municipal bonds lost their tax-exempt status. Without the incentive of below-market interest rate financing, many entrepreneurs simply could not afford to take the risk of starting new businesses in declining urban areas.

The rehabilitation tax credit is but one of the tax incentives that entrepreneurs and businesspeople have used for both their own and the public's advantage. I also use the tools of capital formation that were existent at the start of the Reagan administration and were significantly enhanced by the Economic Recovery Tax Act of 1981. These incentives and tools were created not because Congress and the president wanted people like me to get rich, but because they wanted people like me to put other people to work. They wanted people like me to invest more capital into productive enterprises, because they knew that capital formation is the necessary building block of economic growth. They had specific objectives in mind as well.

The tax code has long been used to achieve economic and social goals. In 1981, one goal was to provide an indirect subsidy to an integral and suffering sector of our economy, basic industry. The subsidy took the form of a lower cost of capital, which was accomplished by tax incentives. The continuation of the investment tax credit encouraged investment in modern machinery and equipment, which helps our smokestack industries compete internationally. The depreciation schedule, which Reagan labeled "obsolete, needlessly complex and economically counterproductive," was shortened and simplified in order to encourage investment in new plant and equipment.

The tax writers also had as a goal the encouragement of new technologies. They lowered the tax rate on long-term capital gains to encourage investors to take risks on start-up, speculative companies, many of which are in high technology areas. Tax credits for research and development were created to encourage the design and use of new technologies and to reward risk takers who supplied needed capital. These and many other tax incentives were introduced to meet the goals of increased productivity, job creation, economic growth and international competitiveness.

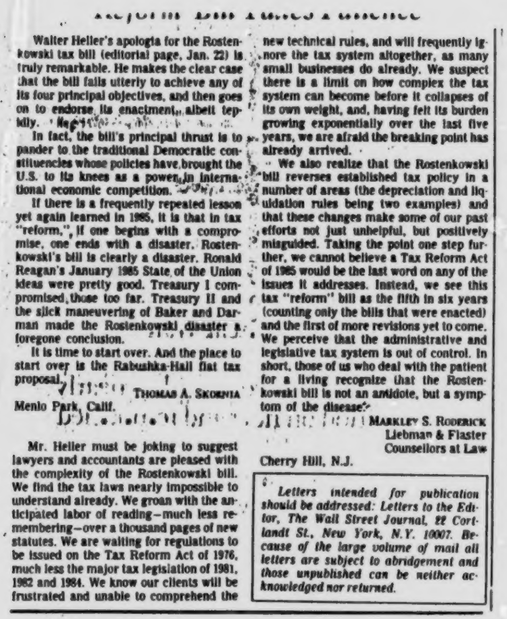
Now, with the proposals to strip the tax system of these tools of capital formation, there must be an equally persuasive set of goals, something to replace growth, productivity and so on. For it is apparent that the tax reform proposals will not simplify the system, they are not equitable in their impact and they will hinder economic growth. The reform plans will tip the risk/reward ratio away from reward and they will dramatically increase the cost of capital.

Either Reagan has completely recanted the philosophy of his first term — or, the goals of this round of tax reform have degenerated into the purely political. I do not believe that the president has given up on entrepreneurship and economic growth. Rather, tax reform has taken on a life of its own, at an increasingly cynical political level. What should have been a bold effort to unleash the productive energy in our economy has become a crusade by a few lawmakers to resurrect and advance their personal political goals. I can think of no worse basis on which to "reform" the system.

Jonathan Butcher is chairman of Butcher and Co. Inc.

For the rate of return that would be allowed under the Reagan plan, I might as well put my money in Treasury bills or municipal bonds, where I have considerably greater chance of seeing return

Business Journal
THE BUSINESS TIMES OF PHILADELPHIA



Walter Heller's apologia for the Rostenkowski tax bill (editorial page, Jan. 22) is truly remarkable. He makes the clear case that the bill fails utterly to achieve any of its four principal objectives, and then goes on to endorse its enactment, albeit tepidly.

In fact, the bill's principal thrust is to pander to the traditional Democratic constituencies whose policies have brought the U.S. to its knees as a power in international economic competition.

If there is a frequently repeated lesson yet again learned in 1985, it is that in tax "reform," if one begins with a compromise, one ends with a disaster. Rostenkowski's bill is clearly a disaster. Ronald Reagan's January 1985 State of the Union ideas were pretty good. Treasury I compromised those too far. Treasury II and the slick maneuvering of Baker and Darman made the Rostenkowski disaster a foregone conclusion.

It is time to start over. And the place to start over is the Rabushka-Hall flat tax proposal.

THOMAS A. SKORNIA

Menlo Park, Calif.

Mr. Heller must be joking to suggest lawyers and accountants are pleased with the complexity of the Rostenkowski bill. We find the tax laws nearly impossible to understand already. We groan with the anticipated labor of reading—much less remembering—over a thousand pages of new statutes. We are waiting for regulations to be issued on the Tax Reform Act of 1976, much less the major tax legislation of 1981, 1982 and 1984. We know our clients will be frustrated and unable to comprehend the new technical rules, and will frequently ignore the tax system altogether, as many small businesses do already. We suspect there is a limit on how complex the tax system can become before it collapses of its own weight, and, having felt its burden growing exponentially over the last five years, we are afraid the breaking point has already arrived.

We also realize that the Rostenkowski bill reverses established tax policy in a number of areas (the depreciation and liquidation rules being two examples) and that these changes make some of our past efforts not just unhelpful, but positively misguided. Taking the point one step further, we cannot believe a Tax Reform Act of 1985 would be the last word on any of the issues it addresses. Instead, we see this tax "reform" bill as the fifth in six years (counting only the bills that were enacted) and the first of more revisions yet to come. We perceive that the administrative and legislative tax system is out of control. In short, those of us who deal with the patient for a living recognize that the Rostenkowski bill is not an antidote, but a symptom of the disease.

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From the Wall Street Journal
Friday, February 7, 1986

February 10, 1986

Statement For the Record -- Senate Finance Committee Hearings on the House Bill 3838, Tax Reform

Senators:

The following is a statement for the record of the Senate Finance Committee hearings on tax reform. The areas covered by this statement relate to those portions of HR 3838 the House Bill which most directly affect the real estate industry in the United States. The general philosophy motivating the following is that tax reform may be a noble idea in principle, but in practice it is a dangerous and destructive force in a business community which must constantly adjust to perturbations in the law which always affects its bottom line. It is urged that the Senate reconsider the utility of many of the changes suggested by HR 3838. The following comments relate to 1) depreciation, 2) the At-Risk Rules; 3) Rehabilitation Tax Credit; and 4) alternative minimum tax.

Depreciation

Few areas of the tax code have undergone greater fluctuations in the last ten years than the rules for depreciation. Whether called by euphemisms such as "accelerated cost recovery", "incentive depreciation system", or "capital cost recovery system", the only important issue for the business community is the speed at which they can recover an investment in capital property.

In 1981, Congress passed the Economic Recovery Tax Act ("ERTA"), under which act depreciation schedules were shortened, thus allowing businesses to write-off their investments speedily. Subsequently, this country has undergone the most prolonged business expansion since the 1960s. It is no accident that inflation and unemployment have been reduced simultaneously, because businesses were encouraged to improve their plants and equipment, and investors were encouraged to utilize venture capital in real estate and other investments, all of which business activity created jobs.

Nonetheless, beginning with the 1984 "Deficit Reduction Act", wherein real property depreciation was extended to 18 years, depreciation schedules have slowly crept upward again, with the current rate as set by the Imputed Interest Act at 19 years for real property, whereas in 1981 the rate was set at 15 years. The trade-offs made by the 1984 Act and Imputed Interest Act necessitated this 30% increase in the eyes of Congress. Now, the "reformers" wish to abrogate totally the message which the flip-flop President and Congress gave to business only a few years ago by completely restructuring the depreciation system and increasing depreciation from 19 to 30 years for most real estate and 40 years in certain special cases.

Lest Congress ever say that tax reform is a pristine matter, let it also be noted that there are substantially shorter rates for low and very-low income housing. Even the reformers cannot avoid the obvious and correct use of the tax code to encourage business to invest in socially responsible programs in which they would otherwise not be inclined to invest because of the high risks and low rewards.

What will be the result of such dramatic increases in depreciation schedules? First, rents will increase dramatically in order to offset the drop in the effective rate of return on investment caused by the lower write-off attributable to the lengthened depreciation schedule. Such a rent increase will affect the low and middle income citizens who cannot afford to purchase their own home. These increases may range from 10% to over 30% to achieve such an offset, and will wipe out or even exceed the tax saving to such low and middle income families which will be engendered by lower tax rates. Revenue neutrality to the government thus translates into disposable income neutrality for the taxpayer as well--just the opposite of what the reformers wish to achieve.

At Risk Rules

The extension of the at-risk rules of Code Section 465 to cover real estate will also hinder investment. Although the proposed law contains an exception for third-party financing, it is not clear why that exception is present. It would be far more logical for the Code to limit the at-risk rules to real estate investments which are financed by loans from related parties since the mere fact that the seller of a property may take back financing is not in and of itself an indication that the financing will not be negotiated at arm's-length. Given the new OID rules of Code Section 1272 et. seq. and their application to real estate, it is most likely that the financing will have been negotiated strenuously so that no collusion on the interest rate or other terms thereof would be possible. Moreover, because the seller's sole protection for its loan is the property, a seller will not be inclined to allow overvaluation if he is to take back financing, since foreclosure on a worthless property is not what any seller-mortgagee seeks.

There already exist severe penalties for the overvaluation of depreciable property -- the loss of the writeoffs and the repayment of back taxes, with interest, can deal a crushing blow to the over-aggressive taxpayer. However, as stated, it is wrong to equate seller financing with overvaluation, as the House Ways and Means Committee does (cf. Committee Report at p. 293).

Historic Property Rehabilitation.

The changes made to the tax credit for the rehabilitation of older and certified historic properties will prevent most future investment in this extremely successful and important area of investment opportunity, which was created in most part by the Economic Recovery Tax Act of 1981. Essentially, the proposed tax bill will adversely affect the rehabilitation tax credit investment in the following manner:

1. The credit itself is reduced from 25% to 20% for certified historic structures and 10% for structures originally placed in service before 1936.

2. The taxpayer will have to take a basis reduction equal to the amount of the credit; under current law, the basis reduction need only be for one-half the amount of the credit.

3. The taxpayer will only be permitted to depreciate the property over a 40-year span, rather than 19-year span, as under current law, or a 30-year span as is proposed for most other real estate under the proposed tax bill.

4. Losses passed through to limited partners investing in an historic rehabilitation project which are in excess of such limited partner's cash basis will be subject to the proposed alternative minimum tax.

These severe cut-backs to the advantages of investing in an historic rehabilitation project, will nearly totally eliminate any incentive for an investor to put his money into such a program. Historical rehabilitation projects are generally risky and involve property in "fringe" areas, where, absent the tax incentives appurtenant to the investment, venture capital otherwise would not flow.

For example, the credit has been responsible thus far for $6.7 million of equity capital raised to finance renovations at the Frankford Arsenal in Philadelphia, PA; for the renovation of the entire Philadelphia neighborhoods known as "Franklintown" and "Olde City", where numerous dilapidated warehouses and row-homes have been replaced on the City's tax rolls; and for the reconstruction of Union Station in St. Louis, MO. These previously blighted areas and buildings could have continued to deteriorate absent the tax credits and depreciation advantages created by the 1981 Economic Recovery Tax Act.

The Committee Report recognizes these advantages when it states, "such incentives are needed because the social and aesthetic values of rehabilitating and preserving older structures are not necessarily taken into account in investors' profit projections. Additionally, a tax incentive is needed because market forces might otherwise channel investments away from such projects because of the extra costs of undertaking rehabilitations of older or historic buildings."

The resounding success of this tax incentive should be a red flag waving in the face of Congress to indicate the retention and even expansion of the advantages giving rise to the investment. Instead, the Bill drastically reduces the return on investment inherent in any historic rehabilitation and thereby negates any reasonable risk-return ratio. The cuts in the Bill seem to have been made in the face of the Committee Report which extols the necessity of tax advantages for rehabilitation. No explanation at all is given for the Bill's action in changing the basis reduction from one-half of the ITC to the full amount thereof (for certified historic structures), nor is there any discussion of why such a building need be depreciated over 40 years instead of 30, as for most other real property. Such changes drastically reduce the viability of a certified historic or other rehabilitation in any year beyond that in which the property is placed in service. If anything, the depreciation rules should be relaxes for historic buildings, as they are for low income housing, and the half-basis reduction should be retained. At the least, however, this program should be saved in no less than its current form.

Alternative Minimum Tax

Section 501 of House Bill HR 3838 (the "Bill") sets forth proposed amendments to the Alternative Minimum Tax ("AMT") section of the Internal Revenue Code ("Code"), i.e. Code Section 55. The proposal as written contains serious structural and theoretical flaws which serve to detract from its goal of making the tax system more equitable. Further, the proposal will have a deleterious effect on capital formation and economic expansion, and will cause substantial confusion and excessive paperwork in the compilation of returns, thus effectively negating any hope that tax reform would be equivalent to tax simplification.

The major problems of the proposal are as follows:

1) AMT Rate. The current AMT is calculated at 20% rate, representing 40% of the maximum "regular" tax of 50%; the proposal would raise the AMT to 25% while lowering the maximum regular tax to 38%, thus making the AMT equal to 66% of the regular rate. Unlike the regular tax, the AMT is not a "marginal" tax, but a flat tax on preference items. By raising the AMT rate so it is proportionately a greater amount relative to the maximum regular rate and equivalent to the "mean" regular rate, the Bill really has created an entirely new tax system. Individual taxpayers with income in excess of $20,000 ($40,000 for married couples) (the "zero bracket amount" for AMT) will then have to compute their tax liability twice, causing unnecessary paperwork and time expenditure. Furthermore, fairness dictates that the effective rate of the AMT be no greater than it is currently, i.e. 40% of the maximum tax rate, which, under the proposal, would indicate a 15% AMT. The Bill reflects such a coordination of the present effective rate of certain taxes with the proposed rate under HR 3838 in the following areas, among others: a) alternative minimum tax [where 3/25 of the net capital gains for the taxable year are

excluded from the calculation of tax preference items, thus ensuring that "individuals at the top marginal rate will not be subject to a higher rate of tax on capital gains under the minimum tax than under the regular tax." (House Report at pg. 315)]; and b) the investment tax credit for certified historical rehabilitation, where the credit is reduced from 25% to 20% in order to achieve an equivalent effective offset against income under a maximum marginal tax rate of 38% as that which currently exists with a maximum marginal tax rate of 50%.

2) *Taxation of Losses.* Page 306 of the Committee Report on HR 3838 states, "fairness and taxpayer morale have been particularly harmed by the proliferation of tax shelters, whereby individuals with substantial economic in effect purchase tax benefits that are not accompanied by significant economic burdens."

Although the House's frustration with abusive tax shelters is understandable, the AMT is not the proper forum and the proposed revisions are not the proper method of curing such perceived ills. The proposal will create a "phantom income" tax on limited partners' (or "passive" general partners') allocable losses in excess of cash basis. It means that, for all intents and purposes, investors will be taxed when they have *losses* as well as when they have *profits*. No provision is made for an offset of taxes paid on these losses when taxes are due on profits! In effect, taxes may arise in the absence of *any* economic gain throughout the course of the project.

3) Contradictions With Other Code Provisions. Additionally, the proposal undermines Code Sec. 752 and the regulations promulgated thereunder which allow partners, limited or general, to include partnership debt obligations in their basis, subject to certain rules concerning recourse and non-recourse financing. By not allowing debt as a part of AMT basis, the Bill once again is essentially creating a whole new system which in some cases is antithetical to the "regular" tax system.

Further, the new and extensive regulations for Code Section 704(b) made final in December, 1985 relating to "substantial economic effect" thoroughly address the issue of making certain that all partners, limited or general, pay -- in the literal sense -- for any losses which render their individual capital accounts negative. No partner is permitted to abscond with losses unless she "zeros-out" her capital account by taking money OUT OF POCKET to replenish these losses. If Congress is concerned about the timing of this replenishment (cf. House Report p. 306, "In case of a passive investor in a business activity, the Committee believes that losses by the activity are not truly realized by the investor prior to the disposition of his or her interest in the activity".), then the solution should lie in the revamping of the 704(b) regulations, perhaps by requiring investors to pay back "excess" losses with interest at the applicable federal rate. The AMT should be an income tax, not a losses tax or a separate tax system. Better yet, Congress could consider lowering the percentage of allowable writeoff attributable to preference items when the aggregate amount of those preferences exceeds a certain dollar figure. This would eliminate the cumbersome AMT altogether and still prevent taxpayers from "sheltering out".

Finally, there is no sense in differentiating the passive investor from the active investor in terms of whether or not a loss is "suffered". The 704(b) regulations do not draw such a distinction, yet the proposed AMT amendments do. Are "money" partners who use their capital to fund a business venture to be treated differently from the "ideas" partner? Why? What tax distinction can or should be drawn, and why, if at all, draw it in the AMT? If Congress is looking to destroy capital formation, it has found a way to do so.

4) Retroactivity. The AMT proposal is also unsatisfactory because it is retroactive. Partners and investors who united in years prior to 1986 will be subject to the provisons of law which simply did not exist when their investment vehicle--partnership, limited partnership or S corporation, was created and their economic expectations engendered and structured. A

"passive" partner in any partnership may find herself subjected to a serious tax liability under a tax system which did not exist when the partnership was founded. Such retroactivity is unfair in the most severe sense because it punishes investors who entered into and have based their investment decisions and income expectations on previously formed capital investment structures. It is impossible to comprehend the massive confusion and deleterious impact the proposal would have on EXISTING partnerships, many of which require continual monetary input to remain viable, let alone the halt such a proposal would cause to any future investments. Why, after all, take a chance if the tax system will penalize a loss?

If Congress is looking for a way to shore up tax shelters, perhaps it should take a page out of the investment interest limitation rules of Code Section 163 which "matches" investment interest with investment income. Thus, losses from passive investments which are tax shelters could be limited to an amount equal to the taxpayer's investment income plus a certain percentage of the taxpayer's non-investment income (e.g. 25%).

Such a matching would still allow investors to experiment with venture capital in such socially beneficial programs as historic property rehabilitation, oil and gas exploration, timber harvesting and reforestation and low-income or HUD housing, because the investor would be allowed a return in terms of tax advantages for his risky investment. It is possible that an individual investor, especially lower to moderate income investors, will not have investment income sufficient in and of itself to "cover" investment losses; thus, it is necessary to include a certain proportion of non-investment income to the potential "shelter" formula in order to permit the above-described return to be realized. Code Section 163 has a similar provision by allowing a $10,000 "floor" amount against which investment interest may be written off before investment income must be taken into account.

5) Favoring Wealthy Taxpayers. The above discussion raises one further problem with the proposed AMT revisions, which problem also exists concerning the proposed changes to Code Section 163, as set forth in Bill Section 402. Essentially, these two provisions serve to further the interests of the wealthiest taxpayer at the expense of the less wealthy and middle-income taxpayer. Such is the case because only the wealthy will be able to invest substantial cash amounts in partnerships in order to avoid the proposed AMT taxation of losses, whereas the average taxpayer, who must leverage, cannot do so under the proposed AMT without being punished; and, with respect to the addition of all "non-business" interest (as separate from other "non-business"

deductions) to the laundry list of offsets against investment income, it is clear that the wealthy taxpayer who has substantial investment income will not be hurt as much as a middle-income investor who suddenly finds that she cannot deduct investment mortgage interest because she does not have a $50,000 stock and bond portfolio.

These provisions should be eliminated in their entirety to allow middle-income taxpayers a return by placing their capital at risk in a business venture which they do not actively run. Such an activity need not be a "shelter" in order to have losses, and investment losses are no less "real" (especially given the 704(b) regulations) than active business losses. Congress should encourage venture capital, not penalize it. A tax on success is one thing, a tax on failure is quite another.

Thus, the proposed changes to the AMT are unnecessary and improper both in form and in substance. The perceived "problems" which the reformers wish to address are directly addressed quite thoroughly by other areas of the Code, and the actual structure of the proposals is retroactive, anti-capital formation and skewed in favor of the wealthy investor. Appropriate alternatives are set forth above where applicable.

Conclusion

In sum, there are numerous good reasons why Congress should retain the current tax status attributed to real estate. The House Report to HR 3838 itself reveals and posits the successes attributable, for example, to the rehabilitation tax credit, yet Congress and the President persist in their quixotic, yet misplaced, attempt to emasculate the very provisions of the Code which have created the economic recovery which they laud. The Tax Code is the most effective method of sending a signal to business investors, yet the investment community continues to cry "foul" to tax "reform". Such cannot bode well for this country's economic future.

Congress should realize that the tax reform has not and will not meet its original goals of simplification, economic expansion and disposable income increases. The thousands of pages of text and Committee Reports do little more than further confuse and complicate the Code and, in many cases, serve to emasculate the very programs which the President and Congress themselves originally encouraged--and which have been resounding successes. It would be best for tax reform to die a natural death; nothing could better signify the President's and Congress' commitment to economic growth.

Statement on Tax Reform
Before the Committee on Finance, U. S. Senate
by Michael S. March, Ph. D. #

RESTORE FISCAL RESPONSIBILITY WITH SOCIAL EQUITY

Early reports on the first $11.7 billion of Gramm-Rudman automatic budget reductions for fiscal 1986 show that they will bite into the muscles of several important agencies such as the Internal Revenue Service. This is a foretaste of devastating cuts to come. To eliminate the present $220 billion annual deficits solely by budget cuts will mean further reductions 17 times as large as this first increment, all successively more deleterious to the mission of the U. S. Government.

The back-to-back combination of the Gramm-Rudman cut-the-budget amendment as signed by the President and the "revenue neutral" tax bill proposed by the President and passed by the House under the leadership of Chairman Dan Rostenkowski is not the right solution to the Government's budget problems. These two pieces of legislation do not deal realistically, adequately, or fairly with the fiscal crisis which besets our country. Our nation cannot afford the devastating social costs which this new set of Reganomic fiscal actions would require. This nation needs statesmanship in the Congress to restore our national finances sensibly to a healthy condition.

I believe that your Committee will find very few informed fiscal policy experts who would not support action to reduce the $220 billion annual Federal deficit. But a review on the facts relating to the deficit lead to the conclusion that the U. S. Government needs a tax bill which raises more revenues. It cannot withstand blind,meataxe budget cuts which fall indiscrimnently on essential public programs which already have been hard hit by tens of billions of prior cuts. Moreover, in this time of huge deficits it would be national folly to give large tax rate cuts to well-to-do people who received disproportionately large tax reductions in the 1981 tax bill sponsored by our President. Such action would be a clear demonstration that this President and the Congress have no regard for the public interest.

There are several important factual points about procedure and substance which underly the foregoing conclusions.

What Caused the Enormous Budget Deficits?

During my quarter of a century in the machinery of the Presidency it became clear to me that in our Government the President must be the guardian of fiscal integrity and be the main molder of proper national priorities. Except in rare instances the Congress is not effective in protecting the Treasury. The Congress will cut taxes almost any time a President will let it. It is still ill-adapted to setting major priorities coherently.

President Reagan has taken advantage of these weaknesses in the makeup of the Congress to create huge deficits in his abortive efforts to dismember social and other domestic programs he and his supporters dislike. The result is that his policies are hurting the nation fiscally, economically, and socially. This is the time for the Congress to demonstrate that it can act decisively in the national interest!

Although as candidate Mr. Reagan held himself out as a fiscal conservative in 1980, his budget and tax policies as President can only be characterized as reckless. Very soon after entering the White House he submitted to the Congress a $1.6 trillion 5-year defense expansion program which has doubled the annual rate of military outlays. Instead of making provision for raising taxes to finance these exhaustive expenditures, Mr. Reagan simultaneously

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sponsored the largest tax reduction in our history--$750 billion over 5 years as enacted by the Congress with its added large liberalizations. That 1981 bill gave half of its tax reductions to the richest one-sixth of American households. Most of our nation's leaders and opinion shapers are undoubtedly in this favored group. Not only were they spared from paying their proper share of taxes for the increased defense outlays, they were given tax cuts!

This doubling of defense spending while cutting taxes sharply is the reason why the deficits under President Reagan have grown from $80 billion in 1980 to an estimated $220 billion in fiscal 1986. Indeed, my analysis of OMB and CBO data shows that for the Reagan years 1981-88 the cumulative deficits in excess of the 1980 rate closely parallel his increases in defense outlays plus the resultant increases in debt service. About 95 % of the increase in budget deficits (and in the public debt) during these Reagan years is explained by the administration's failure to finance the burgeoning defense outlays on a pay-as-you-spend basis. My computation of the actuarial present value of future interest payments on the public debt thus incurred by President Reagan shows that the cost of his defense increases to the nation has been doubled because of this "credit card" method of financing.

Mr. Reagan's 1981 mistaken program is the reason why the U. S. Government debt has doubled to $2 trillion in the last 5 years, even with large cuts in domestic budgets which reached an annual rate of about $50 billion in 1984. CBO analyses of those cuts and of the 1981 tax bill reductions showed that the combined effect was extremely regressive. Is the nation ready for more of the same to cure the huge ongoing deficits resulting from the President's erroneous and misguided policies?

The deficits are in the "Federal funds" accounts ("general funds") which finance military and general government functions. The "Trust fund" accounts, including Social Security, Medicare, and Civil Service Retirement, in recent years have been collectively growing at a rate of around $50 billion yearly, thus offsetting the huge "Federal funds" deficits. (See 1986 Budget Special Analyses, p. C-8.) As President Reagan himself has now repeatedly stated, Social Security does not create the budget deficit.

Despite its huge fiscal costs, Reaganomics has not produced the promised re-industrialization and other economic benefits. There is much evidence that these policies are at the root of high interest rates, the too-high rate of ongoing inflation which many observers believe will escalate, the growing burden of regressive interest payments from the Treasury, and the export deficit which has converted America into an international debtor nation. On the social side, budget cuts have hard hit the poor, the minorities, the children and youths, and especially the elderly whose benefit and health cuts run into the tens of billions and are continuing.

The Growing Fiscal Crisis and Its Impacts

Now, in 1986, the President with considerable support in the Congress is using the excuse of the $200-billion-plus deficits, which his policies have created, to engineer further cuts in domestic budget programs to the "absolute minimum". Meanwhile, he is pressing the Congress to provide a continued 3 % real rate of growth in the defense budget and simultaneously pushing the enactment of a "tax reform" bill which will not produce any net revenue increase toward his deficit, which he blames on the Congress. Indeed, he threatens to veto any tax increase bill.

If no additional taxes are enacted and signed by the President, and the President and the Congress are not successful in agreeing on ways to reduce the deficit to meet the statutory Gramm-Rudman targets, automatic formula cuts will go into effect each year, to be shared 50/50 between defense and the rest of the unprotected part of the budget.

Given the recently estimated $220 billion figure for the deficit in fiscal 1986, as reduced by the automatic Gramm-Rudman cuts of $11.7 billion now in process, the required reductions for fiscal 1987 would total between $50-75 billion if the $144 billion target for the deficit in that year is to be met. The advance word is that the President's 1987 budget will propose massive reductions in domestic programs. There would still remain $144 billion in deficits to be eliminated in the next 4 years.

The options for cutting these deficits are (a) tax increases, (b) expenditure cuts in domestic programs as the President wants, and (c) increased revenues from economic growth. Low productivity and the indexing of the personal income tax, which started in 1985, severely constrict the possibility of substantial growth of revenues. If no tax increases are enacted, budget cuts of over $100 billion each will have to be made in defense and domestic expenditures during the 5 fiscal years 1987-91 if Gramm-Rudman automatic cuts remain in force. If this happened, the President's national security build-up of the last 5 years would have to be substantially dismantled --and the same would happen to a large part of the social welfare and other domestic programs built up in the last 50 years. If all the $200-plus billion of the cuts were to be made in the domestic programs, incredible damage would be done to the human side of our society. In contrast to this enormous damage from budget cuts, the Reagan-Rostenkowski tax bill proposals to reduce present taxes for the rich, and especially to cut tax rates, appear ridiculously inappropriate and untimely. But these tax reductions for the rich are the very heart of second-term Reaganomics. They are intended to benefit the rich at the expense of the ordinary people and to shackle the Federal budget for years to come in a huge structural deficit which will make any attention to the social and human needs of the nation impossible. It is significant that the administration has not issued any forthright information on the impacts of the budget cuts--and on the distributional impact of the budget cuts and tax shuffles now under way. The Congress should insist on such factual information. Not just dollars and deficits are involved--people are deeply affected, especially people in the lower income classes who depend on Government aid.

In all of U. S. history never has the U. S. Government been thrust by its political leaders into such a deep, self-imposed, and crippling fiscal crisis. Never have policy decisions which could lead to the destruction of vital programs for human resource investment, for economic and infrastructure development, and for benefits and services for the dependent groups in the population which are so heavily dependent on the Government, been proposed, enacted, and even implemented without informing the Congress and the nation of the impacts and consequences of such action--or without even considering the needs of the people. The leaders of the U. S. seem to be on automatic pilot to destroy everything in the U. S. Government which is humane and socially responsible.

Apart from the forthcoming 1987 budget (which many in the Congress reportedly regard as dead before its arrival), two of the critical sets of decisions faced by the Congress revolve around the pending "tax reform" bill and the disposition of the mindless Gramm- Rudman process, perhaps by its repeal. These two sets of decisions are closely related, like the front and back of a coin.

The House Tax Bill Fails to Serve the Needs of the Nation

The Reagan-Rostenkowski "tax reform" bill falls far short of the President's announced goals of "fairness, simplicity, and economic growth." It makes some progress toward achieving more equal treatment of taxpayers with equal incomes and levying minimum taxes on corporations and individuals. But these gains are more than offset by serious deficiences in the House-passed bill, which basically follows the President's Reaganomic prescriptions.

The House tax bill fails to meet two governing criteria for a responsible tax bill, namely revenue adequacy for public needs and equity or equality of sacrifice among taxpayers with incomes which differ greatly. The latter principle supports progressive taxation at rates which equalize the marginal rate of sacrifice as incomes increase. More specifically, the House bill now before the Senate Finance Committee shortchanges the country in the following respects:

1. It turns its back on the key principle that the Government should raise enough revenues to cover expenditures deemed to be in the public interest. It does not meet the highest priority need of our nation in the present circumstances, which is for more revenue to reduce and eventually eliminate the irresponsible $200-plus billion annual defiots created during the first Reagan term.

These large structural deficits are exacerbated by the 1981 "tax COLAS" which began in calendar 1985 for individuals. The deficits are running at 5 % of GNP. They are undermining our economy and our dollar, creating an ever-larger regressive public debt burden of non-productive outlays from the Treasury, and are strangling the vital social and general welfare activities of the Government.

It is not tax reform in these circumstances to follow the reckless 1981 tax reductions with a 1986 bill which raises no net revenue to cover the rampaging deficits--and which authorizes reductions in present tax rates for individuals and corporations costing $222 billion over the next 5 years. While such reductions may buy the allegiance of certain high-income groups by freeing them further from paying their proper share of taxes to support the growing defense effort, including the rapidly-growing Star Wars initiative, the public interest is not served by such cuts at this time. These rate reductions should be deferred by the Congress until the budget is balanced--and the savings should be earmarked specifically for reduction of the deficit. If the affected individuals and corporations are responsible, they will agree to this sacrifice.

2. The House bill provides net reductions in personal income taxes totaling $140 billion over the next 5 years. President Reagan and the House Committee on Ways and Means have repeatedly given out statistics which cause the public to think that the biggest cuts are for the poor--but the truth is that, as in 1981, these cuts are overwhelmingly for the rich.

Omitted from the thick House Report 99-426 on the bill are relevant distributional statistics which show that the average net personal tax reductions for the favored rich group are some 23 times as large as those for the numerous poor and lower middle income group. More exactly:

O Three percent or fewer than 4 million individual tax units with incomes exceeding $75,000 a year would receive net personal tax cuts totaling $40 billion over the next 5 years. This is 30 % of the total personal income tax reductions--while the President is proposing to rip the domestic programs for common people of this country to shreds on the grounds that the Government faces a crisis because of the deficits.

Within this group, the very rich whose incomes exceed $200,000 per year and who constitute only half of 1 % of total tax returns would carry off some 14 % of total personal tax reductions.

O In contrast, 61 million returns constituting 51 % of the tax population and having incomes under $20,000 annually would receive net personal tax reductions of $30 billion in 5 years, or just 22 % of total personal tax cuts. They number 15 times as many as the 4 million in the rich group, but their overall dollar share is just 3/4 that of the rich group. A great majority of the 27 million elderly over age 65 have adjusted gross incomes below $20,000--but the elderly have taken heavy budget program cuts.

Within the under $20,000 category the estimated tax returns with incomes under $10,000 a year number 34 million. The Ways and Means Committee has given wide publicity that their taxes were cut 76 % on the average and that 6 million would be freed entirely of income taxes. What was not revealed was that the total tax reduction for these 34 million is only some $1.7 billion for 1987, an average of only $52 per annum per household. They have borne the horse's share of the budget cuts so far, but receive a rabbit's portion of tax benefits. The rich have been little affected by budget cuts, but their tax cuts are a horse's allowance.

O The disproprtionately large personal tax rate cuts for the top income brackets represent a wholesale retreat from the principle of progressive taxation on the basis of ability to pay and equal sacrifice among income brackets. The Reagan administration is not satisfied with the 1981 reduction of the top bracket rate from 70 % to 50 %; it seeks reduction in 1986 to a top rate of 35 %--a large step toward flat rate taxation. Mr. Rostenkowski's bill, pushed through the House without a record vote, sets a 38 % top rate. Our most equitable tax, the personal income tax, would thus be diminished in its progressivity and its revenue production in the Federal system. And this while we need the revenue very much.

The flattening of top rates for the personal income tax would give the taxpayers with incomes over $100,000 a year nearly twice as big a boost in aftertax incomes as that received by the under $10,000 group and two other middle income groups. The argument that top rate tax cuts will benefit the economy is conjectural. Where is the evidence that the so-called incentive effects from cutting the top tax rates will be worth the loss in Federal revenues and will be more beneficial than the social losses from requisite budget cuts stemming from the revenue loss? Certainly, the low income people are still waiting for the benefits of the 1981 Reagan tax cuts to "trickle down" to them, witness the rates of poverty and unemployment.

As former OMB Director David Stockman stated while at OMB, "supply side" economics was just a convenient excuse to justify tax cuts for the rich. Since leaving OMB he has stated that the effort to cut social programs had shown that the nation wanted to keep them--and that the U. S. needs a $100 billion a year increase in taxes. Retention of the present personal and corporate tax rates would take us on the way to over 40 % of his tax goal.

It should be noted that President Reagan's "tax reform" bill as submitted in 1985 provided much sharper cuts for the rich and much less for the poor than the Rostenkowski bill, which has the above regressive implications.

O It has not surfaced in public debate, but the House bill's replacement of the 5-year personal tax reductions of $140 billion with tax increases in corporate income taxes totaling $139 billion represents a further major step toward a more regressive tax system. Inevitably a substantial proportion of the increased corporate income taxes would be passed through in price increases to consumers and have a regressive effect, much like a sales tax which hits low income people more heavily than the rich as a proportion of their incomes. This impact would hit the millions of the poor who get no benefit whatever from the proposed personal tax cuts.

O The replacement of the personal tax cuts with increases in corporation taxes is an "iffy" proposition. It is being hotly contested by some business groups on the legitimate grounds that this will have a depressing effect on business capital investment--which was the Reagan administration and Congressional argument in 1981 for corporate tax reductions. A good deal of the present corporation tax increases now being attempted represents a withdrawal of 1981 and earlier excessive and non-productive "tax expenditure" benefits to business.

Unfortunately for tax equity, even more regressive alternatives than the corporate income tax are being discussed in the Congress and the administration: Increased gasoline or energy taxes and/or a value added or a transactions tax. These would all be buried in the cost of goods and services and would be far more regressive than the present personal income taxes, especially if the latter were left at present rates and adjusted to close loopholes. It will be up to the Congress to protect the ordinary people of America from the Reagan administration's effort to foist new forms of hidden, regressive, consumption taxes on the American public while it cuts personal income taxes for the rich by wagonloads.

O The Reagan administration is also pushing the whole Federal-state-local fiscal system into a more regressive mode. This is the prime consequence of the elimination of Federal equalizing grants which are financed by somewhat progressive Federal taxes , which grants are not replaced by state or local governments or, if replaced, are financed by generally quite regressive local taxes or by state taxes which are less progressive than Federal taxes. Moreover, the administration has sought to double tax state and local government funds by denying state and local taxes as a deductible item in computing Federal personal income taxes so, in effect, people would pay taxes to the Federal Government on their state and local taxes. The Rostenkowski bill continues the deductibility of such taxes, but the issue will be fought in the Senate.

The Budget Cutback Route to Cover the Deficits Would Damage the Nation

Congressional assessment of the legitimacy and feasibility of eliminating the $ 220 billion Federal deficit through budget spending reductions must start with consideration of the background of the problem:

O When he announced for the Presidency in November 1979, Mr. Reagan castigated previous Presidents for their economic "disaster" because their deficits ("printing press money" he said) had totaled $448 billion in the 34 years since World War II had ended. In his first 5 years President Reagan ran up deficits which have more than doubled the public debt of $916 billion when he took office.

O In his "America's New Beginning: A Program for Economic Recovery", February 18, 1981, President Reagan presented to the Congress a Budget Reform Plan which projected a small budget surplus for fiscal year 1984. His 1986 Budget (p. 9-60) reported an actual deficit of $175 billion for 1984, plus $10 billion more in off-budget deficit.

O In his "New Beginning" document Mr. Reagan represented that his budgets would run surpluses after fiscal 1984 even though his plan included the largest tax cut in history of this country.

In actuality, his tax cut as enacted in 1981 has, by his own estimates in the 1986 Budget (p. 4-4), caused reduced revenue collections ranging from $168 billion in fiscal 1985 to a projected $283 billion in 1988. His budget deficits for 1985 and 1986 exceed $200 billion a year.

O In his "New Beginning" document Mr. Reagan laid out his 5-year $1.6 trillion defense plan, but without providing revenues to cover the projected doubling of expenditures. Indeed, he sponsored the largest tax cut in history. His 1986 Budget shows an increase in nation defense expenditures from $134 billion in fiscal 1980 to an estimated $286 billion for 1986. (p. 9-48)

O In his "New Beginning" document Mr. Reagan promised "adequate funding of essential social safety net programs, including cost-of-living protection for the elderly." (p. 8) But even in 1981 budget cuts were made in "safety net" programs huge cuts were proposed in Social Security in 1981 and 1983--and in 1983 COLA denials and other changes were made in Social Security which are depriving recipients of some $10 billion a year by continuing benefit reductions. Medicare, also included in the original Safety Net, has been cut by many billions and continues to be a big target of further reductions. By the end of 1984 domestic programs had been reduced by some $50 billion annual rate, the great bulk from social benefit and human investment programs such as health and education. COLAS are being denied to Federal retirees.

Several conclusions emerge from a review of the Reagan record:

1. His promises, projections, and statements are unreliable.

2. This President is responsible for having wrecked Federal finances on a scale equalled by no prior President.

3. This President's program is based on ideology, not on facts. Based on what he has proposed and done as President, his goals are to: Redistribute Federal tax and budget resources to the rich and to take them from the poor and lower middle classes. Reduce taxes, especially for the rich, as a way of forcing cutbacks in Federal spending for domestic and particularly social programs. Increase military spending and do so by cutting social programs. Fortunately, the Federal Government as it has evolved in the last 50 years has a much greater regard for the compassionate and humane treatment of deprived and dependent people than President Reagan's philosophy envisions. His goals, as a practical matter, would destroy the U. S. Government's role in promoting the general welfare and the public health, safety, and welfare.

4. President Reagan and his associates are very able in bluffing the Congress in pursuit of his ideological goals--but when he sees that he clearly lacks the votes, he does back off and compromise. The fiscal mess he has created is now so serious and so evident, his 1987 budget cut proposals are so ridiculously unreasonable and damaging to the fabric of necessary Government, and his "tax reform" proposals are so out of line with the harsh necessity of replacing or restoring some of the feckless tax cuts

made in 1981, that Mr. Reagan's 1986 program must be restructured by Congressional leaders, Republicans and Democrats working side by side, into a more reasonable set of proposals so the U. S. Government can continue to serve the American people.

5. A key defect in President Reagan's thinking is that the National Government is not useful or even necessary, except to defend the country. He is wrong. The Government provides the foundation of laws, rules, and programs on which the private economy is built. The social and regulatory programs are vital for the health, economic security, financial security, and the protection of every American. It is the responsibility of the Congress to protect the system of Government which enables our society and our economy to function.

The implementation of the Gramm-Rudman cut-the-budget provisions would severely damage the U. S. Government if the Reagan-Rostenkowski tax bill is enacted without changing it to raise substantial revenues. Some examples of the results include:

O If the automatic cuts continue to be divided 50/50 between defense and domestic programs , so reductions of over $100 billion are made in e̲a̲c̲h̲ of them from 1987 to 1991, the Reagan defense build-up will be largely wasted, but at the same time the domestic programs will be devastated even more because they are already reduced.

If Gramm-Rudman is changed to impose the cuts solely on domestic and social programs, they will be damaged so severely that the U. S. will be rolled back to the 1930s in its people programs--into the status of a third world country as far as social protection. Millions of the elderly will be reduced to poverty, lose their health benefits, and be denied hospital and nursing home care. Children likewise.

The first step the Congress should take is to demand explicit information from the President on what the effects of Gramm-Rudman would be by 1991.

O Gramm-Rudman would cripple the U. S. Civil Service and make a Federal career completely unattractive. Civil Service retirees were the first to lose their COLAS. Their median annuities are just $966 a month and survivors receive only $423.--but the U. S. Government has reneged by violating a permanent law enacted in 1962 to provide inflation protection to retired employees who had spent their lives in work paid well below private sector rates.

Active Civil Servants are to be denied a pay increase at a time when private workers, who are already higher paid, are in line to 6 % raises and business executives have been getting 11 %. Worse yet, some 200,000-350,000 Federal employees could lose their jobs by 1991. The Civil Service is the backbone of the U. S. Government. Does the President want to destroy the career service? Do the President and the Congress intend to continue reneging on Civil Service Retirement benefits by amending provisions after workers have retired in reliance on duly-enacted statutes of the U. S. Government? Can anyone trust this Government to discharge its statutory obligations to its workers or retirees who earned rights by serving under contributory plans?

Gramm-Rudman is the opposite of a proper and sensible method for budgeting public resources:

a. The amendment was whipped through the Congress without public hearings .

b. The Federal agencies, the Congress, and the public were not advised, before its passage and Presidentil signature, what its impacts and consequences would be.

c. It violates every rule of sound budgeting and subverts rational budgeting by creating a mindless, "no hands", formula-directed process for cutting the budget by flat percentages clear down to small activities. There is no weighing of benefits v̲s̲ costs, or of the relative worth of programs in apportioning reductions. Quick-spend appropriation accounts are hurt disproportionately because of slow-spend accounts in the computation of the cut-back percentage.

d. It deals with spending cuts, not with the trade-off between cuts and tax increases, in its process. Implicitly, it proposes to eliminate deficits in their entirity by expenditure cuts, without considering that imprudent, manipulative actions may have caused the deficits.

e. The constitutionality of the amendment is in doubt, raising further questions whether this amendment also makes inroads into existing provisions for open and responsible fiscal decision-making.

f. Gramm-Rudman is a big step away from clear separation of executive and legislative duties and functions in the budgeting and taxing fields in which the public can determine who takes what action and can hold the President and members of the Congress responsible and accountable for their particular actions. It also bundles diverse programs together to be handled mechanically, by formula, whereas the decisions being made are actually of a policy nature and ought to be handled separately in many cases and voted on separately by the Congress.

Gramm-Rudman is contrary to the practice and spirit of the fiscal decision-making processes in the Federal Government as they have been and ought to be practiced. The Congress ought to repeal this ill-considered, Reaganomic amendment, over the President's veto, if needed.

Solve the Crisis by Fiscally Responsible and Equitable Means

The crisis over $220 billion Federal deficits cannot be solved by budget cuts. The source of the problem is that huge tax cuts were made in 1981 simultaneously with huge increases in defense spending. Domestic programs have already been hurt by budget cuts--to cut more will hurt millions of people who need and deserve help in this economy which produces $16,000 of GNP per capita annually.

In the first Reagan term budget cuts for the poorer people and tax reductions for the rich redistributed national resources from the poor toward the rich. Even larger budget cuts for fiscal 1986 and 1987 are again aimed at the poor and the middle class, and the Reagan-Rostenkowski "tax reform" bill gives the rich big tax cuts while hitting the poor and the middle class with more taxes once we consider the pass-through of corporate and possible other consumption taxes. This process will shove the poor deeper into desperation, shrink the middle class some more, increase the concentration of income and wealth in the hands of the very rich--and in the end undermine our democracy. The Congress has a solemn public responsibility to halt this destructive set of changes in our society. Bi-partisan action is needed.

The Federal budget can be restored to a reasonably balanced basis step by step over the next 5 years by carrying out normal, rigorous budget review of defense and domestic spending and by reshaping the pending tax bill to raise revenues by successive increments of $50 billion for 3 years so $150 billion will be raised by 1989.

The modified tax bill To Promote Fiscal Soundness and Equity in Taxation would substitute closing of major, inequitable loopholes as identified by the administration and the Ways and Means Committee for the pending extensive "reform" bill. In a real sense the proposed bill would make the reforms most pertinent to solving the budget crisis--namely, raising needed revenues and closing loopholes to increase distributional equity by:

1. Retaining existing tax rate schedules for corporate and personal income taxes, with adjustment of the standard deductions and earned income credits for low-income people to compensate for inflation.

2. Implementing effective, inescapable minimum taxes of, say 20 %, for higher income individuals and corporations where assorted loopholes are used to escape or minimize taxes, e. g., the special defense exclusion.

3. Repealing the wasteful Investment Tax Credit and tightening the treatment of depreciation allowances along the lines of H. R. 3838.

4. Repealing the indexing of individual income taxes to reduce the structural deficit and enhance countercyclical stabilization .

5. Restricting tax subsidies for IRAs, income deferment plans, private pensions, etc., in which the proceeds are payable as supplements to the basic Social Security payments. Make restrictions prospective by capping deductible contributions by high earners.

6. Repeal the tax exemption on municipal bonds for industrial purposes; raise capital gains taxes; and levy a national defense surtax on higher individual and corporate incomes.

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Mortgage Bankers Association of America

STATEMENT OF

MORTGAGE BANKERS ASSOCIATION OF AMERICA

for submission to the

COMMITTEE ON FINANCE
of the
UNITED STATES SENATE

For the Record on the Hearing
on
HR 3838, the "Tax Reform Act of 1985"

February 4, 1986

The Mortgage Bankers Association of America* submits this statement on the President's tax proposal and the provisions of HR 3838, the "Tax Reform Act of 1985" and their impact on housing and real estate investment.

MBA supports the overall thrust towards simplicity and fairness in the tax laws affecting the American people. MBA looks forward to working with the Administration and Congress on tax reform, especially on issues crucial to housing and real estate finance.

The President has said our tax system should reflect American values and should encourage investment and risk taking. These are the bulwarks of our economic system—our growth, innovation, and entrepreneurship. Homeownership and investment in real estate have long been regarded as integral parts of our national economic and social priorities, and our tax system has reflected these goals. Investment and risk taking are of great concern to Americans, especially at a time when our long-term economic growth rate appears to have slowed relative to earlier in the postwar period. Investing in real estate carries potential risk. Values rise and fall with business cycles. MBA believes that some of the provisions of the tax bill passed by the House of Representatives, HR 3838, the "Tax Reform Act of 1985," could adversely affect the housing industry by reducing the incentives to invest in rental housing and commercial real estate, and could lead to higher rents and lower property values.

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*The Mortgage Bankers Association of America is a nationwide organization devoted exclusively to the field of housing and other real estate finance. MBA's membership comprises mortgage originators, mortgage investors, and a wide variety of mortgage industry-related firms. Mortgage banking firms, which make up the largest portion of the total membership, engage directly in originating, selling, and servicing real estate investment portfolios. Members of MBA include:

- Mortgage Banking Companies
- Commercial Banks
- Mutual Savings Banks
- Savings and Loan Associations
- Mortgage Insurance Companies
- Life Insurance Companies
- Mortgage Brokers
- Title Companies
- State Housing Agencies
- Investment Bankers
- Real Estate Investment Trusts

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MBA has identified the following provisions of HR 3838 as those most relevant to the housing and real estate finance industry and as those that would affect homeownership and investment in rental and commercial property. These are:

Single-family homeownership

— Full deductibility of mortgage interest expense on a principal residence and a second home. MBA supports the full deductibility of all mortgage interest expense.

— Preservation of the full deduction for real property taxes. MBA supports this.

Multifamily rental housing

— A limitation on the deduction of nonbusiness interest expense to $10,000 ($20,000 joint), including passive investment interest, plus net investment income. MBA opposes any limitations on interest on investments in real estate.

— A lengthening of the depreciation period for real property to 30 years, using the straight line method. MBA supports consistency and certainty for capital cost recovery because real estate investment decisions require long-term planning.

— An increase in the capital gains tax rate for real property subject to depreciation. MBA supports appropriate capital gains treatment.

— An extension of at-risk rules to certain real estate activities. MBA supports the continued exclusion of real property from the at-risk rules.

- A state volume limitation on tax-exempt obligations of state or local governments where the proceeds are targeted to meet the housing needs of the low-income, the elderly, and the handicapped. MBA opposes this limitation because needed housing would not be built.

- Amortization of rehabilitation expenses for low-income housing. MBA supports this incentive.

- A reduction of the tax credit for qualified expenditures incurred in connection with the rehabilitation of certain old or historic buildings. MBA supports Federal tax incentives encouraging the rehabilitation of historically designated income-producing properties.

- Retroactivity, as well as the mismatch, of effective dates. The uncertainty and unfairness resulting from this should be corrected.

- An alternative minimum tax. MBA is concerned about its impact on real estate investment.

HOMEOWNERSHIP AS A NATIONAL PRIORITY

Homeownership has been the American dream as long as there has been an America. Throughout the history of our country, homeownership has been a national priority. The first European settlers established their homes on the coast of the new continent, and when the newly formed Nation pushed westward, the government promoted individual ownership of private property by homesteading acts. When our country underwent urbanization and waves of immigrants landed on our shores, the hallmark of individual achievement and success as an American was the purchase of one's own home. For the last 50 years, as has been apparent in our housing programs and in our tax code, it has been an economic and social goal of our Federal government actively to foster the growth of homeownership. Decent and affordable housing for all Americans is one of the basic tenets of our democratic society.

Current Tax Law

From its inception, the tax code has recognized the importance of homeownership as a priority in the American value system. It has been tax policy to make homeownership more affordable for as broad a spectrum of Americans as possible. Purchasing a home is the biggest expenditure most Americans will ever make, and the annual cost of owning a home is a large part of their budget. Because the costs of both purchasing and owning a home are very sensitive to our tax laws, the Internal Revenue Code has always contained provisions which act as incentives for Americans to purchase their own homes.

Since the beginning of the Federal income tax laws, the deductibility of home mortgage interest has enabled many Americans to buy and own homes. In addition, tax law allows Americans to deduct state and local real property taxes from their adjusted gross income. These deductions make homeownership more affordable by reducing the effective cost of owning a home. Thus, by reducing the after-tax cost of homeownership, the tax code has enhanced the ability of Americans to afford their own homes.

MBA has compared the 1986 after-tax cost of homeownership for three income groups under current law, the President's tax proposals, and HR 3838 (Exhibit 1). For families currently in the 18 percent marginal tax bracket ($20,000 taxable income), the after-tax cost of homeownership would increase 8 percent under the President's proposals and 5 percent under HR 3838. For families currently in the 25 percent marginal tax bracket ($30,000 taxable income), the after-tax cost of homeownership would increase 14 percent under the President's proposal and would remain the same under HR 3838. For families currently in the 33 percent marginal tax bracket ($40,000 taxable income), the after-tax cost of homeownership would increase 13 percent under the President's proposal and 9 percent under HR 3838. MBA believes keeping the after-tax cost of homeownership as low as possible is consistent with long-standing tax policy.

HR 3838, THE "TAX REFORM ACT OF 1985"

Tax reform has been fostered by the general impression that the current tax code is unfair, overly complex, and a hindrance to economic growth. HR 3838, like the President's tax proposals, focuses on the lowering of marginal tax rates for individuals. In order to do this without losing revenue, the amount of income subject to taxation is increased by the elimination or restriction of deductions, credits, and preferences, some of which affect housing. The impact of these changes will cause Americans to reevaluate their investment decisions.

Limitation on the Deductibility of Interest

Under current law, there is a limitation on the deductibility of investment interest expense; but nonbusiness interest expense, including mortgage interest expense, is not subject to limitation. In general, under HR 3838, the deduction for all nonbusiness interest expense would be limited to the sum of $10,000 ($20,000 joint) plus net investment income plus mortgage interest expense on two residences. The President's tax proposals would have limited the nonbusiness interest deduction to $5,000, plus net investment income plus mortgage interest expense on a taxpayer's principal residence.

HR 3838 recognizes that encouraging homeownership is an important policy goal, achieved in part by providing a deduction for residential mortgage interest. Therefore, the limitation on interest in HR 3838 does not affect the deductibility of interest on debt secured by the taxpayer's principal residence or a second home.

MBA believes the deductibility of mortgage interest expense on residences is consistent with this Nation's long-standing commitment to homeownership opportunities for all American families and opposes any restrictions on the deductibility of home mortgage interest. For the first time in the history of the Internal Revenue Code, mortgage interest expense would be subject to limitation. MBA supports the full deductibility of mortgage interest expense.

MBA is especially concerned about the provision in HR 3838 that subjects a limited partner's share of the limited partnership's interest expense to the nonbusiness interest limitation. Multifamily residential projects financed by limited partnerships could be sharply curtailed as their attractiveness as an investment vehicle would diminish. MBA opposes any restrictions on the deductions for interest on investments in real estate.

The Deductibility of Real Property Taxes

HR 3838 would preserve the full deductibility of real property taxes by homeowners. The President's tax proposals would repeal this deductibility. MBA supports the position adopted by the House of Representatives. Any restraint on this deduction would directly impact the American homeowner by increasing the after-tax cost of homeownership and adversely affecting the relative price of housing. MBA urges the Senate not to lose sight of the important social purpose of adequate housing currently fostered by the present tax code. To leave intact the full deductibility of real property taxes is an acknowledgement of the significant role it plays in making homeownership more affordable to more Americans.

MBA has analyzed the impact of the provisions of both HR 3838 and the President's tax proposals on the first-year after-tax cost of homeownership by family income in 16 metropolitan areas. Under HR 3838, which would allow the full deductibility of real property taxes, the increases in the first-year after-tax cost of homeownership for families with incomes of $25,000 range from 4 percent to 7 percent. The increases for families with incomes of $50,000 are 9 percent in 15 metropolitan areas and 10 percent in one (Exhibit 2).

Under the President's tax proposal, which repeals the deductibility of real property taxes, the increases in the after-tax cost of homeownership for both family income groups in all 16 metropolitan areas are greater than under HR 3838. The increases for the $25,000 family income group range from 6 percent to 15 percent. In some areas, such as Philadelphia, Houston, Milwaukee, and Detroit, the increase in the after-tax cost of homeownership is doubled under the President's tax proposal, while in a number of other areas the increase is almost doubled. For families with incomes of $50,000, the increases under the President's tax proposals range from 10 percent to 17 percent (Exhibit 3).

MBA would like to point out that if the Senate repeals the deductibility of real property taxes, the impact on the homeowner would be similar to the increase in the after-tax cost of homeownership under the President's tax proposals.

MBA opposes any limitation on the deductibility of real property taxes. Any increase in the after-tax cost of homeownership would require American households, especially those with low and moderate incomes, to spend a larger share of their incomes for housing or to reduce the quality of their housing accommodations.

Depreciation Period for Real Property

HR 3838 replaces the current Accelerated Cost Recovery System (ACRS) with the Incentive Depreciation System (IDS), which groups assets into 10 classes. Most real property would be in Class 10 and be depreciated over 30 years using the straight line method. Beginning in 1988, the depreciation deduction would be increased when inflation exceeds 5 percent. In that event, the adjustment is one-half of the inflation rate in excess of 5 percent.

MBA believes that this change, one of a series of disruptive changes over the past several years in the length of the depreciation period for real property, is unwise. Numerous changes in depreciation periods enacted since 1981 have created long-term planning uncertainties.

Prior to 1981, depreciation deductions were allocated over the useful life of the property. The Economic Recovery Tax Act of 1981 eliminated this approach and replaced it with the Accelerated Cost Recovery System (ACRS), under which the cost of assets is recovered over predetermined recovery periods. The recovery period for real property from 1981 to 1984 was 15 years. The Deficit Reduction Act of 1984 increased the minimum real property recovery period to 18 years for property placed in service after March 15, 1984. On October 11, 1985, President Reagan signed P.L. 99-121, amending the tax code sections dealing with imputed interest and lengthening the recovery period again—effective May 9, 1985—from 18 years to 19 years. If HR 3838 is passed, recovery periods would again be lengthened, this time to 30 years.

MBA supports consistency and certainty in the tax treatment of capital cost recovery for real estate. In order to continue to attract investment capital, the recovery period should be a certain term of years and should remain stable over time. Real estate investment decisions require long-term planning and are enhanced by the ability to make long-term projections. The frequent changes for cost recovery in recent years from useful life to 15 years to 18 years to 19 years and then the change to perhaps 30 years, as proposed by HR 3838, hampers the ability of lenders and investors to make sound and reliable long-term plans.

Furthermore, MBA believes that the indexing provision to adjust depreciation deductions only partially for inflation will not adequately compensate investors for the loss in cash flow associated with the substantially longer write-off period.

Multifamily projects would be hit especially hard. Multifamily rental housing would be subject not only to an increase of more than 50 percent in the length of the recovery period, but also to a change from the accelerated method to the straight line method. The effect of these changes is to reduce an investor's return on investment, especially in the early years. Even if gain on disposition is greater under HR 3838, the time value of money makes the larger depreciation deductions in the early years worth more to an investor than greater gains in later years.

This would diminish the attractiveness of multifamily rental housing as an investment vehicle, with the effect of reducing construction. The reduced supply of such housing would mean that rents would rise. This effect on the renting taxpayer could possibly offset any benefits the taxpayer receives because of other provisions in HR 3838.

While MBA believes constant tinkering with the cost recovery system has a deleterious effect on investment in housing, it also recognizes that any tax reform proposal might result in changes in the depreciation system. MBA urges the Senate to provide for shorter recovery periods than those in HR 3838, coupled with accelerated deductions. Making investment in multifamily rental housing more attractive than is provided for in HR 3838 would help maintain an adequate stock of such housing to meet the rental needs of American families.

Capital Gains Tax Rate

MBA supports the continuation of appropriate capital gains tax rates for the sale or disposition of real estate. Such treatment attracts investment capital to construction and real estate development, which in turn contributes to a healthy economy.

Under HR 3838, the top effective tax rate for capital gains would increase from 20 percent to 22 percent. MBA believes that increasing the capital gains taxes on investments in multifamily housing could reduce the supply and boost rents.

The Treasury Department recently released the results of a study on the capital gains tax cut in 1978. In its Report to Congress on the Capital Gains Tax Reductions of 1978, dated September 1985, the Treasury Department concludes that the capital gains rate reduction from 49 percent to 28 percent "will over time cause the rate of investment, the capital stock, national income, labor productivity and the overall standard of living to be higher than if the tax treatment of capital gains had remained unchanged."

The Extension of the At-Risk Rule to Real Estate Activities

HR 3838 extends the at-risk rules to holding real property with exceptions for certain arm's-length, third-party nonrecourse financing. MBA opposes the application of the at-risk rules to holding real property.

The at-risk exception in HR 3838 for arm's-length, third-party nonrecourse financing would apply to a large number of financing transactions. However, any further limitation on this exception would have a drastic impact on the ability to raise equity to finance multifamily housing.

Tax-exempt Financing for Multifamily Low-Income Housing

MBA is pleased that HR 3838 would continue the tax exemption for interest on state and local obligations where the proceeds are targeted for housing for the low-income, the elderly, and the handicapped. MBA supports efforts to make adjustments to the qualifying criteria in order better to serve low- and moderate-income households. MBA also is pleased that low-income housing would continue to receive depreciation deductions that act as an incentive to investors. MBA also applauds the exception for low-income housing from the interest deduction limitation and the at-risk rules.

However, MBA opposes the imposition of the state volume cap on tax-exempt bonds used for multifamily rental housing. This restriction would diminish the important role that this financing tool plays in fostering multifamily housing production for the targeted group. Because Federal spending to subsidize this construction has been cut drastically, tax-exempt financing is one of the few remaining vehicles available to promote multifamily housing production. Not only would the cap mean that needed low-income housing would not be built, but it would pit the participants in the tax-exempt arena against one another for the limited allocation.

Providing adequate housing for the low-income, the elderly, and the disadvantaged has long been a social policy of the Federal government. It should be remembered that when the private sector provides tax-exempt financed low-income multifamily housing, it is carrying out a public purpose. Under current law, such bonds are not subject to the state volume cap for this very reason.

Rehabilitation Expenses for Low-Income Housing

MBA supports the changes made by HR 3838 to Section 167(k) of the Internal Revenue Code. The five-year amortization of rehabilitation expenses for low-income rental housing would be made permanent and the aggregate limit on such expenses would be increased from $20,000 to $30,000 per dwelling unit. This five-year amortization has been repeatedly extended since its original enactment in order not to interrupt the rehabilitation of low-income projects. In recognition of the desirability of retaining this incentive, HR 3838 would continue this provision without expiration. Rehabilitated, as well as newly constructed, rental housing for the low-income is needed to provide all Americans with decent housing.

Historic Rehabilitation Tax Credit

HR 3838 replaces the current three-tier rehabilitation tax credit with a two-tier credit. The credit for rehabilitation of certified historic structures would be lowered from 25 percent to 20 percent, and depreciable basis would be fully adjusted for the amount of the credit. The historic rehabilitation credit would apply to both residential and nonresidential buildings.

MBA supports Federal tax incentives aimed at encouraging the rehabilitation of historically designated income property. The rehabilitation and preservation of historic structures are an important national goal.

Construction Period Interest

HR 3838 effectively lengthens the recovery period for interest associated with the construction of real property from 10 years to 30 years. Under current law, interest is amortized over 10 years. HR 3838 would change its character to a capital expense, include it in basis, and depreciate it over 30 years. In the case of low-income housing, interest would be changed from a current deduction to a capital expense, thereby lengthening the period of its deductibility from one to 30 years.

MBA believes the effect of this change would be increased rents in order to offset the loss of the deduction in the early years. MBA supports current law affecting the treatment of construction period interest.

Alternative Minimum Tax

While HR 3838 provides a number of incentives for investment in rental housing that were not in the President's tax proposals, their effect is in large part nullified by the imposition of a 25 percent alternative minimum tax on a number of deductions designated as preference items.

Tax exemption for interest on low-income multifamily housing bonds is continued for regular income tax purposes, but this benefit is greatly reduced by its inclusion as a preference item at the 25 percent minimum tax rate.

The bill includes as a preference item losses from limited partnerships that are more than the taxpayer's cash basis. In the case of a registered tax shelter, as provided for in the 1984 tax act, the amount of cash basis that the taxpayer can take into account in one year is limited to $50,000, even though the cash basis exceeds that amount. Losses otherwise deductible would be subject to the 25 percent minimum tax.

Incentive depreciation on real property placed in service after 1985, to the extent it is in excess of nonincentive depreciation, is treated as a preference. Nonincentive depreciation for real property other than low-income housing is 40 years, straight-line. This minimum tax on depreciation for real estate only aggravates an already adversely affected situation.

Effective Dates

MBA is deeply concerned about the effective dates in HR 3838. A number of provisions affecting housing would become effective January 1, 1986, if no changes are made. However, because some of these provisions may be changed by the Senate Finance Committee, the housing industry currently is in the position of having to guess what the consequences will be for decisions that require long-term planning.

The price of multifamily rental housing cannot be determined without knowing what depreciation treatment will apply and what the amortization period will be for construction period interest. Other provisions that would be retroactive are the at-risk limitation on losses, new restrictions on tax-exempt bonds for low-income housing, the first-year phase-in of interest deductions limitations, and a stiffer alternative minimum tax.

One of the goals of the tax revision effort is to promote economic growth, not deter it. Which combination of incentives for capital formation is most effective is the subject of much discussion and dissension. Meanwhile, a pall of uncertainty hangs over the housing industry, delaying and deterring market activity and slowing growth.

MBA is also concerned about the mismatch of effective dates. Taxing a larger tax base at current rates for half of a year cuts in half the potential tax benefit associated with lower marginal tax rates.

Effect on Capital Values

Capital values will likely suffer under the new depreciation system and higher capital gains rates. If property values are adversely affected, the principal amount of existing mortgages could exceed the values of the underlying properties. When mortgage loan-to-value ratios are high, the risk of default increases. The investor's equity in the properties will have disappeared and along with it the incentive to keep investing more money in those properties. This is especially true in periods of low inflation when property values have little or no expectation of appreciation and investors see scant prospect for returns on investment.

CONCLUSION

HR 3838, the "Tax Reform Act of 1985," eliminates or restricts tax deductions, credits, and preferences in order to lower individual tax rates on the grounds that the tax system will be fairer. It may also be thought that individuals will save a larger share of their incomes and provide more funds for investment. Yet the evidence from the 1981 tax cut provides little support for the view that lower marginal tax rates increase the rate of personal saving. MBA believes that reducing the Federal deficit is the path to increased national saving, lower interest rates, and faster economic growth. The Federal government is competing with the private sector in the capital market for investment dollars. If those dollars were invested in the private sector rather than loaned to the Federal government, we would have the economic growth the President wants and the Nation needs.

MBA urges caution in any change of the tax provisions affecting both single-family and multifamily housing. America prides itself on being one of the best-housed nations on Earth. We have achieved this stature in large measure by the high priority placed on housing by the Federal government. MBA urges Congress not to lose sight of the important social purpose of adequate housing and the variety of provisions embodied in the present tax code, which are still needed to assure a decent home for all Americans.

MBA appreciates this opportunity to present its views and we would be happy to furnish additional information if needed.

EXHIBIT 1

COMPARISON OF FIRST-YEAR AFTER-TAX HOMEOWNERSHIP COSTS UNDER CURRENT LAW, PRESIDENT'S TAX PROPOSAL, AND HR 3838*

	1986 Current Law	President's Tax Proposal	HR 3838
Example 1—House Price: $65,000; Taxable Income: $20,000			
Before-Tax Cost	$ 9,454	$ 9,454	$ 9,454
Marginal Tax Rate	18%	15%	15%
Tax Savings	$ 1,426	$ 772	$ 1,055
After-Tax Cost	$ 8,028	$ 8,682	$ 8,399
Increase in Cost (%)	-	8%	5%
Example 2—House Price: $85,000; Taxable Income: $30,000			
Before-Tax Cost	$12,361	$12,361	$12,361
Marginal Tax Rate	25%	15%	25%
Tax Savings	$ 2,589	$ 1,174	$ 2,589
After-Tax Cost	$ 9,772	$11,187	$ 9,772
Increase in Cost (%)	-	14%	0%
Example 3—House Price: $150,000; Taxable Income: $40,000			
Before-Tax Cost	$21,815	$21,815	$21,815
Marginal Tax Rate	33%	25%	25%
Tax Savings	$ 6,031	$ 4,032	$ 4,569
After-Tax Cost	$15,784	$17,783	$17,246
Increase in Cost (%)	-	13%	9%

*All examples assume a 12 percent, 30-year fixed-rate mortgage with a 10 percent downpayment; property taxes are 1.43 percent of the house value. House prices for each income category are derived from U.S. Census data. Before-tax housing costs are the sum of mortgage payments, property taxes, and an estimate of maintenance, utility, and insurance costs. All tax calculations are based on a married couple filing jointly, and on the average itemizations claimed by taxpayers in the different income categories derived from the Internal Revenue Service publication Statistics of Income.

Prepared by MBA Economics Department
January 31, 1986

EXHIBIT 2

IMPACT OF THE WAYS AND MEANS COMMITTEE PROPOSAL (HR 3838) ON FIRST-YEAR AFTER-TAX COST OF HOMEOWNERSHIP, BY FAMILY INCOME, FOR A MARRIED COUPLE FILING JOINTLY*, IN SELECTED METROPOLITAN AREAS

Metropolitan Area/State	$25,000 Family Income			$50,000 Family Income		
	Current Law After-Tax Cost	After-Tax Cost Under HR 3838	Percent Change	Current Law After-Tax Cost	After-Tax Cost Under HR 3838	Percent Change
Los Angeles, CA	$11,514	$11,983	4	$14,510	$15,834	9
Denver, CO	8,057	8,425	5	9,457	10,320	9
Bridgeport, CT	8,145	8,521	5	8,247	9,015	9
Atlanta, GA	4,366	4,628	6	7,604	8,303	9
Chicago, IL	6,471	6,795	5	6,879	7,516	9
Baltimore, MD	4,446	4,712	6	4,860	5,315	9
Detroit, MI	3,431	3,669	7	3,701	4,056	10
Las Vegas, NV	8,169	8,540	4	8,633	9,417	9
Newark, NJ	5,135	5,423	6	4,600	5,034	9
New York, NY	7,042	7,383	5	7,380	8,062	9
Philadelphia, PA	3,831	4,079	6	4,490	4,908	9
Memphis, TN	5,091	5,375	6	6,730	7,353	9
Houston, TX	6,085	6,399	5	8,750	9,566	9
Salt Lake City, UT	7,120	7,462	5	9,418	10,281	9
Seattle, WA	8,437	8,818	4	9,855	10,757	9
Milwaukee, WI	7,051	7,396	5	7,209	7,891	9

*Assumes 12 percent, 30-year fixed-rate mortgage, 10 percent downpayment; property tax rates and housing prices for each income category and locality are derived from U.S. Census and Advisory Commission on Intergovernmental Relations data. Total housing costs are the sum of mortgage payments, property taxes, and an estimate of maintenance, utility, and insurance costs.

Prepared by MBA Economics Department
January 31, 1986

EXHIBIT 3

IMPACT OF PRESIDENT'S TAX REFORM PROPOSAL ON FIRST-YEAR AFTER-TAX COST OF HOMEOWNERSHIP, BY FAMILY INCOME, FOR A MARRIED COUPLE FILING JOINTLY*, IN SELECTED METROPOLITAN AREAS

	$25,000 Family Income			$50,000 Family Income		
Metropolitan Area/State	Current Law After-Tax Cost	After-Tax Cost Under President's Proposal	Percent Change	Current Law After-Tax Cost	After-Tax Cost Under President's Proposal	Percent Change
Los Angeles, CA	$11,514	$12,223	6	$14,510	$16,073	11
Denver, CO	8,057	8,636	7	9,457	10,476	11
Bridgeport, CT	8,145	8,830	8	8,247	9,344	13
Atlanta, GA	4,386	4,828	11	7,604	8,499	12
Chicago, IL	6,471	7,048	9	6,879	7,745	13
Baltimore, MD	4,446	4,957	11	4,860	5,535	14
Detroit, MI	3,431	3,942	15	3,701	4,332	17
Las Vegas, NV	8,160	8,731	7	8,633	9,516	10
Newark, NJ	5,133	5,712	11	4,600	5,293	15
New York, NY	7,042	7,634	8	7,380	8,282	12
Philadelphia, PA	3,831	4,299	12	4,490	5,086	13
Memphis, TN	5,091	5,606	10	6,730	7,581	13
Houston, TX	6,085	6,669	10	8,750	9,922	13
Salt Lake City, UT	7,120	7,680	8	9,418	10,476	11
Seattle, WA	8,437	9,047	7	9,855	10.954	11
Milwaukee, WI	7,051	7,750	10	7,209	8,315	15

*Assumes 12 percent, 30-year fixed-rate mortgage, 10 percent downpayment; property tax rates and housing prices for each income category and locality are derived from U.S. Census and Advisory Commission on Intergovernmental Relations data. Total housing costs are the sum of mortgage payments, property taxes, and an estimate of maintenance, utility, and insurance costs.

Prepared by MBA Economics Department
January 31, 1986

STATEMENT BY DAVID J. SILVERMAN, E.A.

CHAIRMAN, TAX SECTION
NATIONAL ASSOCIATION OF ENROLLED AGENTS

ON

H.R.3838

MADE TO THE SENATE FINANCE COMMITTEE

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NEW YORK, NEW YORK 10017
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STATEMENT OF
DAVID J. SILVERMAN
CHAIRMAN, TAX SECTION
NATIONAL ASSOCIATION OF ENROLLED AGENTS
SUBMITTED TO THE SENATE FINANCE COMMITTEE

Dear Mr. Chairman.

My name is David J. Silverman, I am chairman of the Tax Section of the National Association of Enrolled Agents whose members you of course know, are enrolled to represent taxpayers before the Internal Revenue Service.

The National Association of Enrolled Agents supports the work that the committee is doing to reform our tax laws and make them fairer. This need for fairness is of paramount concern to all Americans. It is in this spirit of fairness that I would like to address the members of the committee and urge them to support Section 1546 of H.R. 3838, which would allow enrolled agents and certified public accountants to represent taxpayers in the U.S. Tax Court under its Small Case Procedure. The small, or S procedure was enacted to provide taxpayers with an opportunity for an informal and simplified proceeding when litigating a tax dispute under $10,000 with the Internal Revenue Service. However, taxpayers currently find themselves in the unenviable position of having to disassociate themselves from their closest advisor, their enrolled agent or certified public accountant, if they choose to avail themselves of this informal procedure.

The cost of this disassociation causes the small case to take on the aspects and costs of major litigation, thus leaving the small case procedure small in name only. Since most small case petitions involve factual issues where the IRS refuses to accept a taxpayer's substantiation of a deduction, the National Association of Enrolled Agents believes that the enrolled agent whose demonstrated expertise in the interpretation of the code and its regulations together with their experience in resolving tax issues are more than qualified to represent their clients before the court.

After reviewing the charts that show the dramatic escalation of cases before the court that appear in 1981 and 1982 annual report of the Chief Counsel of the Internal Revenue Service, we believe that the reasons for enacting this legislation are compelling. Attached to my testimony are pages 75 & 28 of these two reports. The tables that are illustrated on these two pages indicate that the number of S cases grew from 3,100 in 1977 to 10,500 in 1981 and 9,800 in 1982. The tax court hears approximately 1,000 cases a year out of its pending caseload of 74,000 cases.

Because many taxpayers lack an effective alternative to proper representation they are forced to proceed pro se before the court. Through my service in 1982 as a member of the Commissioner of the Internal Revenue Service's Advisory Group, I became acutely aware of the pro se problem that both the Chief Counsel's office and court is currently facing. No other single problem on the Advisory Group's agenda received as much attention as that of the pro se petitioner.

Kenneth W. Gideon, former Chief Counsel of the Internal Revenue Service stated in a conversation with me that he would prefer to see petitioners with representation than without. The majority of the pro se petitioners are not aware of the documentation required by law in order to properly substantiate a tax deduction. This lack of understanding consumes an inordinate amount of the court's time. Since most small case petitions involve factual disputes, the court would benefit by having these facts presented to them in a logical and expeditious manner by certified public accountants and enrolled agents who are especially competent in this area.

The Tax Court is straining under its current caseload. It simply does not have the resources to adjudicate all of the cases currently before it. The National Association of Enrolled Agents feels that the correct solution to this problem is not an increase in appropriations in order to hire more trial judges and government attorneys when there is a viable alternative such as Section 1546 of the Act. A great deal of scholarly and practical work has been done in this country with respect to techniques to reduce court dockets. It can be demonstrated that these techniques, when properly applied, have in fact reduced court dockets dramatically.

The National Association of Enrolled Agents believes that Section 1546 of the Act is one that would enhance rights of taxpayers, address the pro se problem and reduce the number of docketed cases through the settlement process without the need for additional appropriations. But more than that, it goes the heart of tax reform. Taxpayers should have the right to have their day in court without it costing an arm and a leg.

I want to thank you for this opportunity to make the views of our Association known to your committee.

Respectfully submitted.

David J. Silverman
Chairman, Tax Section
National Association of Enrolled Agents

Attachments: Pages 75 & 28 of the Chief Counsel's Annual Report for 1981 & 1982

Representative Rostenkowski's letter to Representative Panetta

HR3838.90

Tax Litigation

The Tax Litigation Division determines and coordinates the legal position of the IRS in order to assure consistency in all cases litigated in the United States Tax Court and all cases for refund of taxes and certain suits for declaratory judgment instituted by taxpayers in the United States district courts and the Court of Claims. If the IRS loses a case, the division determines, and advises the IRS with respect to Tax Court cases, whether to acquiesce or nonacquiesce in the decision and, with respect to other adversely decided cases, advises the Department of Justice whether or not to appeal.

During the 1981 fiscal year, a number of significant cases were decided.

- In *Rowan Companies, Inc. v. United States*, the Supreme Court ruled against the IRS, holding that Congress intended the definition of "wages" to be interpreted in the same manner for FICA and FUTA withholding as for income tax withholding, and, therefore, when meals and lodging provided by the employer are excluded from income tax withholding, they are also excluded from FICA and FUTA withholding.

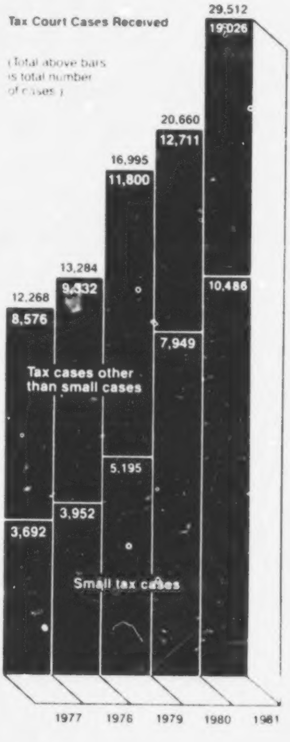
- In *United States v. Darusmont*, the Supreme Court held that the application of an income tax statute to the entire calendar year in which the statute was enacted did not per se violate the Due Process Clause of the Fifth Amendment.

- The Supreme Court ruled for the IRS in *HCSC-Laundry v. United States*, holding that hospital-shared service organizations cannot qualify for exempt status under subsection 501(c)(3), but must qualify, if at all, under subsection 501(e) which governs cooperative hospital service organizations.

- The Supreme Court ruled for the Government in *Commissioner v. Portland Cement Co. of Utah*, holding that for purposes of computing gross income from mining by the proportionate profits method which, in turn, governs a taxpayer's depletion deduction, the first marketable product is finished cement, whether sold in bulk or bags, and that the costs of bags, bagging, storing, shipping, and selling should be included in the proportionate profits computation as nonmining costs.

- The Supreme Court ruled against the Government in *United States v. Swank*, holding that a provision in a coal mining lease permitting termination by either party on 30-days notice did not preclude the lessees from having an "economic interest" in the coal in place which would entitle them to a depletion allowance under sections 611 and 613.

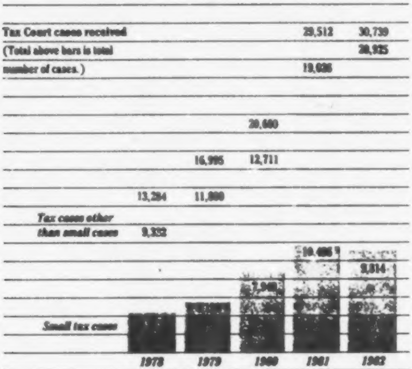
- In *Diedrich v. Commissioner*, the Eighth Circuit ruled for the IRS, holding in direct conflict to previous net-gift holdings in the Fourth, Fifth, and Sixth Circuits, that a donor realized income on the gift of property to his children, who agreed to pay the donor's gift tax liability, to the extent of the excess of the donor's tax liability over his adjusted basis in the property transferred, an issue involving approximately 20 pending cases and between 4 and 5 million dollars.

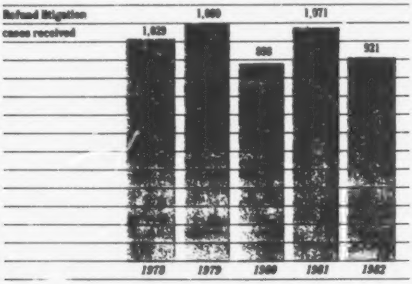


Tax Court Cases Received

(Total above bars is total number of cases.)

	Status	*Court*	*Non-court*	*Total*
Receipt and disposal of general litigation cases	**Pending Oct. 1, 1981**	14,266	1,682	15,948
	Received during year	22,452	5,663	28,115
	Disposed of	19,793	5,879	25,672
	Pending Sept. 30, 1982	16,925	1,466	18,391





members of other barter exchanges to report income and the tendency to report the income in the wrong year provided a reasonable basis for believing the members of the Columbus Trade Exchange may have failed to comply with the internal revenue laws.

TEFRA reduced delays in summons enforcement, since taxpayers no longer will be able to stay enforcement of a third-party recordkeeper summons simply by notifying the recordkeeper not to comply. Instead, objecting taxpayers have to file suit to quash the summons. TEFRA also clarified the Supreme Court decision in *United States v. LaSalle National Bank* by providing that the IRS may use summonses for criminal purposes as long as a referral to the Department of Justice is not in effect.

Tax Litigation

The tax litigation division assures that the legal position of the IRS is consistently presented in all refund cases and cases litigated in the Tax Court, and attorneys from the division argue most of the Tax Court motions—approximately 1,000 a year—set for hearing in Washington, D.C.

The division improved its efficiency in handling the increasing number of Tax Court cases. With a staff approximately the same size as last year's, it increased case closings 29 percent during the year. This increased productivity resulted primarily from the establishment of streamlined procedures for handling small cases and the development of case precedents in significant tax shelter areas to facilitate settlement.

The special trial attorney program finished the year with 169 groups of cases in its inventory, including many of the largest tax shelter groups in the country. For instance, approximately 1,400 separate cases, referred to generally as the London options cases, were consolidated and set for trial in Los Angeles on Jan. 31, 1983.

On June 15, 1982, the Supreme Court in *Diedrich v. Commissioner* upheld the government's long-standing position regarding the income taxation of a net gift transaction, holding that a donor who makes a gift of property on condition that the donee pay the resulting gift tax realizes taxable income to the

DAN ROSTENKOWSKI, ILL., CHAIRMAN

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COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
WASHINGTON, D.C. 20515

TELEPHONE (202) 225-3625

August 2, 1982

The Honorable Leon E. Panetta
431 Cannon Building
Washington, D.C. 20515

Dear Leon:

Thank you for forwarding the letter from your constituent, Timothy Ryan, concerning the Tax Court's procedures for admitting persons to practice before the Court. I apologize for the delay in responding to your letter.

Based on a review of this matter, it appears that Mr. Ryan has made a good suggestion in regard to the so-called "small" tax cases. These cases are ones where the amount of tax in dispute is $5,000 or less. As authorized under Internal Revenue Code section 7463, these cases are conducted more informally, may be heard by Commissioners rather than Tax Court judges, and the decisions cannot be appealed. Many taxpayers do represent themselves in these proceedings.

It appears to me that both the Tax Court and the taxpayer would be better served if the taxpayer were represented by a CPA, an enrolled agent, or an attorney in these proceedings. Most taxpayers are really not well equipped to represent themselves, and it seems counter-productive to permit them to do so while refusing to allow such representation by an enrolled agent or a CPA. I would agree with Mr. Ryan's observation that assistance in developing the case and accompanying the taxpayer to Court are really not sufficient.

I have asked the Committee staff to pursue this matter. I thank you and Mr. Ryan for bringing this matter to my attention.

Sincerely yours,

Dan Rostenkowski
Chairman

DR:ppm

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February 20, 1986

STATEMENT OF

WALTER B. STULTS

Before the

SENATE FINANCE COMMITTEE

PENDING TAX PROPOSALS

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I am Walter B. Stults, President of the National Association of Small Business Investment Companies (NASBIC) which represents the overwhelming majority of all licensed small business investment companies (SBICs) and minority enterprise SBICs (MESBICs). Thank you for giving our Association this opportunity to express its views on the various tax "reform" proposals which are being considered by the Congress and the Administration.

The House-passed tax legislation would decimate our industry and would cripple hundreds of thousands of growth businesses upon which the Nation is so heavily dependent for job creation, technological innovation, competition, and export trade. My statement will cover two major areas: (1) the tax treatment of long-term capital gains and (2) other ramifications of H.R. 3838 on capital formation and business growth.

The Critical Importance of Capital Gains Tax Rates

For SBICs, as for all other investors in American business, the level of Federal taxation of long-term capital gains is by far the most important provision in the Internal Revenue Code. The evidence is irrefutable: a meaningful differential between tax rates on ordinary income and those on long-term capital gains guarantees the essential flow of equity capital to entrepreneurs trying to start new businesses or striving to expand their existing operations.

Pressured in 1969 by Treasury Department officials who claimed the move would generate billions of dollars of additional tax revenues, Congress effectively doubled tax rates on capital gains for both corporate and individual taxpayers. That action all but killed the venture capital industry -- and resulted in lower tax receipts.

Faced in 1978 by Carter Administration pleas to eliminate the capital gains tax differential completely, Congress took a different course. It rejected the experts and cut capital gains tax rates instead. Several members of the present Finance

Committee led the 1978 "revolt" and their faith was soon rewarded when capital gains tax receipts increased. Treasury said: "Capital gains tax rates up; revenues up". Congress said: "Tax rates down; receipts up." All of you know who was correct.

Give Treasury its due, however: it is persistent!! The infamous Treasury I plan of December 1984 once again called for an end to the capital gains tax rate differential. Treasury II reversed course, and the House now proposes the illogical compromise of maintaining a substantially reduced differential for individuals, and elimination of the differential for corporate taxpayers.

I've heard it said that tax rates don't lead to "behavioral response" on the part of corporations. That's nonsense insofar as venture capital is concerned. Dollars are committed to our risky, long-term investment vehicles only after the risk-reward ratio is studied and after alternative uses of the funds are surveyed. The 1969 increase in rates took corporate dollars out of venture capital; the 1978 cut in rates brought corporate dollars back by the billions. If that is not a "behavioral response", I never saw one.

1. The Impact of H.R 3838 on Corporate Venture Capital

Stated as baldly as possible: the enactment of the capital gains provision of H.R. 3838 would devastate the SBIC industry. Ninety percent of all SBICs operate in corporate form; those licensees hold more than 90% of all the capital committed to the SBIC industry. The SBIC industry invested well over one-half a billion dollars in 1985 ($542-million) in 3,093 small firms. The House-passed bill would kiss off that remarkable record.

Furthermore, H.R. 3838 would kill any incentive for other corporations to invest in venture situations. Non-financial corporations have become increasingly important players in the venture capital arena, often providing the larger sums necessary when a growth business requires its third or fourth round of venture capital.

Even Treasury II would have been a disaster for venture capital operations. That proposal called for the corporate capital gains tax rate to remain at 28%, while cutting the top rate on ordinary corporate income to 33%. NASBIC strongly protested that initiative, because it is clear that few corporations would invest their funds in high-risk, long-term investments when the tax rate differential between ordinary and long-term capital gains income was only 5%.

So -- Treasury II was a disaster for corporate SBICs and corporate investors, but H.R. 3838 truly brings us to Armageddon. The flow of venture capital would be reduced significantly, because Stanley Pratt, editor of Venture Capital Journal, has calculated that 41% of all the dollars in the venture capital industry is either held by corporate venture capital firms (including SBICs) or invested by tax-paying corporations.

2. The Impact of H.R. 3838 on Non-Corporate Venture Capital

The Ways and Means Committee and the House retained a capital gains tax rate differential for individual taxpayers, but substantially reduced the attractiveness of venture capital investing. Under present law, non-corporate venture capitalists (individuals and partnerships) pay a maximum tax of 20% on their long-term capital gains -- in contrast to the top tax rate of 50% for ordinary income. That differential has proven to be sufficient to brings tens of billions of dollars into the organized venture capital industry over the past seven years.

H.R. 3838, on the other hand, would significantly pare that differential, taking it down from the present 30% to 16%. The bill achieves that result by cutting the top rate on ordinary income to 38%, while increasing the maximum rate on long-term capital gains to 22%. It is highly doubtful that H.R. 3838 leaves enough of an advantage to induce taxpayers to invest their dollars in high-risk, long-term, illiquid investments where even the "winners" may be illusory, because of inflation.

3. The Impact of H.R. 3838 on Treasury Revenues

Past reductions in capital gains tax rates have brought more dollars to Uncle Sam. That is proven; it's documented. Nonetheless, the Government's tax analysts still maintain that eliminating the capital gains tax differential will produce more revenue. I have not been able to learn the exact figures they whispered into the ears of the Ways and Means Committee, but I understand they claimed the added revenues would be substantial.

That thesis was proven false in 1969, the last time Congress increased capital gains taxes -- and it will prove to be false again if tried this year.

It's unanimously agreed that the Federal Government needs additional tax revenues, not less. History has demonstrated that higher capital gains taxes will decrease revenues, while reasonable cuts in those tax rates will bring in more dollars.

4. NASBIC's Recommendation on Capital Gains Taxes

Treasury II was correct in proposing that a meaningful differential be preserved by calling for a maximum rate of 17.5% on long-term capital gains earned by individuals. NASBIC strongly supports that change. We differ from Treasury II and from H.R. 3838, however, when we urge the Senate and the Congress to bring the capital gains tax rates for individuals and corporations back into parity by cutting the rate on corporate capital gains to the same 17.5%. Historically, the two types of taxpayers had faced the same level of taxes on capital gains, so our proposal is not revolutionary in any sense.

Other Features of Importance to Small Business

In essence, NASBIC finds that H.R. 3838 is an anti-business, anti-investment, anti-capital formation measure. It will stunt the growth of new and small businesses. Its call for a cut in the maximum tax rate for corporations and individuals is an enticing siren's call, but we must look beyond that soothing music. Let me give you several examples:

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Depreciation: H.R. 3838 basically goes back to the old, discredited ADR system of writing off investments in plant and equipment. Small business organizations were unanimous in screaming for the end of that cumbersome procedure which few small firms were able to utilize, although their larger competitors could do so. The simplified depreciation methods adopted in 1981 are extremely beneficial to growth businesses, permitting them to plow back more of their earnings into more jobs and more and better equipment. Can the change embodied in H.R. 3838 be explained in terms of "fairness", "simplicity", or "economic growth"? I believe the evidence is clear: it fails on all three criteria.

Investment Tax Credit: Here is another mechanism which encourages firms to grow and to plow back more of their cash flow and to expand their productive capacity. Perhaps, it's fruitless even to mention this subject, since every so many "experts" agree that the ITC is doomed. I urge your Committee to reject that common wisdom and weigh the interim costs and the long-range gains attributable to the investment tax credit. Other witnesses will, I am sure, deal with this important subject in more detail.

Graduated Corporate Rates: At least, H.R. 3838 does not call for a flat rate on all corporate earnings from the first dollar. That's something to be grateful for, perhaps, but the bill does reduce greatly the advantages of graduation as it exists in current law. The rates are significantly lowered for the most profitable -- but remain about the same for the smallest, or the least profitable.

Furthermore, the recapture provision in H.R. 3838 means that the types of growth businesses in which we invest will soon lose 100% of the graduation -- and well before they are ready or able to compete with giant corporations -- whose rates will have been cut from 46% to 38%. As you know, firms earning between $100,000 and $365,000 will be forced to pay 41% of each additional dollar in profits, and that is significantly higher than the rate imposed on the billion-dollar earners. We believe that graduation should be extended to help meet the needs of such growth firms.

Conclusion

The chimera of a low tax rate imposed equally on every dollar of income, individual or corporate, has great appeal at first blush. But the realities of life soon intrude on this illusion. If we believe the rich should pay higher tax rates than the poor, for example, we depart from our initial thesis. Today's Internal Revenue Code reflects many of the complexities of a modern society.

The powerful job creation machine called small business represents one of our Nation's prime resources. These same growth firms not only make jobs, they also promote strong competition in the economy and introduce technological innovation. Without exception, these businesses require venture capital from outside sources. A realistic capital gains tax differential has proven beyond doubt to be the only method for assuring an adeqaute flow of venture capital.

Our Association and our industry calls upon your Committee to support a capital gains tax rate of 17.5% for both individual and corporate tax payers. This is a tax "reform" which will not cost the Treasury a nickel in revenue and will pay high dividends in fostering economic growth.

Thank you.

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TESTIMONY SUBMITTED

TO THE

SENATE COMMITTEE ON FINANCE

FOR

HEARINGS RELATING TO CAPITAL FORMATION

CONDUCTED ON FEBRUARY 4, 5 and 6, 1986

SUBMITTED:

February 18, 1986

First Vice President: Joan Finney, State Treasurer, Kansas; *Second Vice President:* Thomas Hayes, Auditor General, California; *Treasurer:* Earle E. Morris, Jr., Comptroller General, South Carolina; *Secretary:* Mary Ellen Withrow, State Treasurer, Ohio; *Immediate Past President:* Anthony Piccirilli, Auditor General, Rhode Island

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This testimony is submitted on behalf of the National Association of State Auditors, Comptrollers, and Treasurers ("NASACT"), which for over seventy years has represented financial officers of the States. It concerns two areas affected by H.R. 3838 which are of grave concern to NASACT's members. These are various changes which H.R. 3838 would make with respect to Section 103 (concerning tax-exempt bonds), and also H.R. 3838's exclusion of state and local government employees from eligibility for Section 401(k) cash or deferred arrangements.

As will be described in more detail below, both sets of provisions adversely impact upon the federal/state relationship. The House Bill evidently is based upon the assumption that state and local governments are equivalent to numerous private special interests which must be "reigned in" by tax reform. We feel that this approach is misguided, and that state and local governments should not be compared to private special interest groups. The continued vitality of state government is absolutely essential if our constitutional scheme of federalism is to survive. Indeed, the states are already being asked to bear increasingly heavy burdens as the federal government, spurred by budgetary considerations, cuts back on programs which it has traditionally used to aid the least advantaged members of our society. It is incongruous for the federal government, at the same time, to take away the tools which are absolutely essential if state and local governments are to "pick up the slack."

1. Tax-Exempt Bonds

It has long been a principle of our federal system that interest accruing on obligations issued by state and local governments would not be taxed by the federal government. This tradition is based both on constitutional concerns, and also on state/federal comity. The ability to issue such tax-exempt bonds has long been a tool used by state governments in order to finance essential government services. Several provisions contained in H.R. 3838 would strike at the heart of this ability. Among those are:

> (a) The requirement that five percent of bond proceeds be spent within 30 days of issuance;
>
> (b) The ten percent rule, classifying bonds as nonessential function bonds if even ten percent of the proceeds are used, directly or indirectly, in the trade or business of a nongovernmental party;
>
> (c) The arbitrage rebate requirements;
>
> (d) Inclusion of underwriters discount and associated fees in the definition of bond yield for purposes of calculating the arbitrage amount;
>
> (e) The imposition of burdensome reporting requirements on issuers;

(f) The non-deductibility of bank interest in carrying tax-exempt bonds; and

(g) The January 1, 1986 effective date of H.R. 3838, which is causing cancelation, indefinite postponement or significantly increased costs of urgently needed bond financings.

Each of these provisions will be discussed in turn.

a. Five Percent Expenditure Requirement.

The requirement that at least five percent of all bond proceeds must be spent within 30 days is totally unrealistic and unworkable. In the first place, it is for practical purposes nearly impossible in some cases to expend that large a portion of proceeds on a project in such a short time-frame. Also, the rule does not leave any room for events beyond the control of the issuer. For example, it is highly unlikely that an issuer could expend five percent of the proceeds earmarked for school construction if an unexpected flood occurred, inundating the proposed construction site for two weeks of the 30-day period. It is true that the Treasury Department is permitted to extend the 30-day period in the case of acts of God, but the statute itself should not have such a rigid requirement. Further, this discretionary exception would not always apply. For example, a threatened strike or litigation preventing construction may not be deemed unforeseeable.

Secondly, in at least some instances state or local law prohibits entering into any contracts, including even feasibility studies and the like, before proceeds to pay for the entire project are on hand. This of course, as a practical matter, would make it impossible for the issuer to spend the requisite proceeds within 30 days, since the issuer would first be required to take contract bids and select a contractor, usually a lengthy process. Finally, this provision simply does not make much sense when coupled with other provisions of H.R. 3838. The only justification for requiring such expenditures would be to prevent abusive arbitrage situations. But under H.R. 3838, as discussed below, all arbitrage must be rebated to the United States anyway. Therefore, the early expenditure provisions serves no useful purpose.

b. Ten Percent Rule and Nonessential Function Bonds.

Under H.R. 3838, "nonessential function bonds" are precluded from tax-exempt financing under the Bill. A nonessential function bond is defined in part as any bond issued as part of an issue ten percent or more of the proceeds of which (or $10 million, if less), is to be used in any trade or business owned by any person other than a state or local government unit. Coupled with this provision is the requirement that, if the amount of gross proceeds to be used in a nongovernmental trade or business exceeds $1 million, the amount of such excess is subject to the state volume cap imposed by the Bill. The purported reason for these rules is the belief that, under present law, a significant amount of state and local government bond proceeds are being utilized for private nongovernmental purposes -- e.g. an industrial park.

As presently drafted, however, the actual effect of the Bill would be more than the necessary correction of that problem; indeed it would be a classic example of "throwing the baby out with the bathwater." By focusing upon the user of the facility, rather than the purpose or function of the facility, or who pays for financing this facility (as under present law), H.R. 3838 would eliminate or severely curtail tax-exempt financing for many projects which are undeniably public and provide essential services. If the bill is enacted in its current form, the net result will be, of course, higher financing costs for these projects and a higher taxpayer burden. Correctional institutions, courthouses, and administrative services buildings are all examples of essential governmental services or facilities which could be unjustly impacted by this proposal, merely because of some private involvement with the facilities through furnishing such ancillary services as parking, food and janitorial services, and the like.

Furthermore, this provision would do away with the growing practice of privatization. Privatization simply means that a governmental unit and a private firm work together in partnership to provide services for the community -- services that are the primary responsibility of the governmental unit and are frequently mandated by federal or state law. This is accomplished by the state or local government contracting out to private management companies the responsibility for certain services when it finds such private management to be more efficient and cost effective. Such services are not operated at a profit; rather, privatization merely reduces the tax burden on the government's citizenry by reducing costs of providing the services. Privatization is rapidly spreading because it is efficient and beneficial for the public sector and its citizens. A prime example would be correctional institutions. Many localities, in some cases encouraged by the federal government, have transferred the management responsibilities of such prisons to private contractors. Even though maintenance of prisons is obviously a governmental activity, the presence of the private contractor would deprive such projects of eligibility for tax-exempt financing. Similarly, in some cases it is more efficient for the goverhment to contract out ancillary services. For example, consider a new hospital that anticipates contracting out security, laboratory, pharmacy, food and radiology services, if these services can be provided in a more cost effective manner by the private sector. If these services together would occupy more than ten percent of the hospital's square footage, the government issuer would either be precluded from selecting the least expensive means of providing the traditional government service, or it would be precluded from using tax-exempt financing to fund such services.

All too often, state and local governments are the service providers of last resort, ameliorating the plight of our poorest citizens. By attacking innovative techniques designed to make such support affordable to state governments, H.R. 3838 actually serves to erode local government's ability to provide those essential services, at a time that the federal government is cutting back its support of "safety net" programs.

The proposed unified volume cap makes matters even worse. Even if a project clears the ten percent test, it could easily run afoul of the $1 million threshhold for determining whether the volume limitations will apply. As a practical matter, the volume limitation could itself prevent the project from going forward, depending on what other projects the state government wished to fund. Certain types of projects (such as sewage and solid waste disposal plants, airports, and wharves and docks), which are excepted from the ten percent rule, are also included in the new volume cap. Even though most people would consider these types of projects to be in furtherance of essential government functions, the presence of the volume cap will seriously curtail such projects.

To sum up, it is inappropriate to look to the user of the facility as opposed to the nature of the facility. A governmental function is a governmental function, regardless of who the service provider is. It does not cease being such merely because the governmental unit, in the interest of cost efficiency, contracts with a private company to render the service for the benefit of the general public. Thus, the mechanical ten percent test fails to distinguish between traditional governmental activities and truly private activities.

c. Arbitrage Rebate Requirement.

As alluded to above, H.R. 3838 also extends certain arbitrage restrictions, similar to present law rules applicable to industrial development bonds, to all tax-exempt bonds. Under the Bill, all bond issuers would be required to "rebate" to the United States virtually all arbitrage profits earned through the temporary investment of funds from tax-exempt bonds. Existing arbitrage limitations already effectively do away with tax motivated arbitrage transactions. These limitations, coupled with the new requirement contained in the Bill (with which we do not quarrel) that yield be restricted if expectations of timely expenditure are not fulfilled, will provide sufficient protection against abusive arbitrage by issuers. Therefore, the rebate requirement is unnecessary.

In addition, it is also unfair. The rebate requirement would prevent state governments from using their financial resources in a sound, business-like manner. It is obviously sound business practice to issue all bonds necessary to cover the costs of a project at one time, since this would avoid numerous duplicative transaction costs, as well as possible higher future interest rates at a time when it appears interest rates will rise. Further, it would be irresponsible and unjustifiable for the issuer to invest the resulting proceeds at anything less than market rates during the construction period. Indeed, as mentioned previously, in some cases statutes preclude embarking upon a project until necessary proceeds for the entire project are on hand. In such nonabusive situations, there should be no reason for the federal government to confiscate the arbitrage realized, since the state government was the party which bore the risk of the financial market.

Indeed, the rebate provision may ultimately be counterproductive to the federal government's interests. This is because the volume of tax-exempt bonds in the marketplace will actually increase in order to make up the shortfall which would be caused by the rebate requirement. In other words, bond issuers now "downsize" the amount of bonds issued because they realize that a certain amount of arbitrage, to be applied to the project, will be earned during construction. Since this arbitrage will no longer be available to the issuers, they will have to borrow more funds to build the same project. Also, it is doubtful whether an issuer would bother to invest the proceeds at materially higher yields if it knew that it would have to rebate the arbitrage thus earned to the federal government.

d. Change in Definition of Bond Yield.

The proposed change in calculating arbitrage will lead to unfair results. At present, issuance costs such as underwriter's discounts and letter of credit fees are taken into account in determining bond yield -- in other words, only net proceeds are included in yield. Under the Bill, such issuance costs are ignored for purposes of determining bond yield. Therefore, such amounts will be included in bond proceeds, even though not available to the issuer. Therefore, such costs will result (on paper) in a lower bond yield, which in turn would result in a greater spread between bond yield and investment yield. This would have the effect of increasing the amount of arbitrage deemed to have been earned on the bonds, even though a portion of that arbitrage would be earned only on paper. Since the local government will be required to "rebate" all arbitrage to the federal government, it will in effect have to rebate more arbitrage than it actually earned. In other words, the federal government will be taking a cut off the top of every tax-exempt bond issue. This amounts to a confiscatory tax on the government issuer, and as such implicates grave constitutional questions as well as constituting a totally inequitable practice.

e. Reporting Requirements.

H.R. 3838's tax-exempt bond provisions require that issuers comply with burdensome reporting requirements in the case of all bonds, not just private purpose bonds as under current law. This is totally inappropriate. It will be extremely burdensome for the issuers and, like many other provisions of the Bill, will increase the cost to state and local issuers of financing essential governmental activities.

f. Non-Deductibility of Bank Interest in Carrying Tax-Exempt Bonds.

Under existing law 20 percent of interest allocable to tax-exempt bonds is disallowed as a deduction by the bank holding those bonds. H.R. 3838 increases this disallowance to 100 percent with a transitional exception for bank holdings of essential function bonds and tax anticipation notes issued in state issuers of not more than $10 million annually. The total disallowance of the interest deduction to banks will eliminate bank investment portfolio purchases of tax-exempt bonds. This will narrow the already small market for tax exempts and decrease the efficiency of the market, and ultimately increase interest costs to state and local government.

g. Effective Date.

The January 1, 1986 effective date for most bond provisions in H.R. 3838 has caused extreme uncertainty surrounding the sale of tax-exempt bonds and is having a seriously detrimental effect on projects which state and local taxpayers both need and expect. Even though the bond provisions of the House bill have not been enacted, H.R. 3838 necessarily must be considered by issuers and purchasers of tax-exempt bonds. The House bill dramatically modifies the rules under which tax-exempt bonds may be issued. Since the federal income tax exemption will be contingent upon compliance with the provisions of the House bill, bond counsel generally are unwilling to give "clean" opinions, particularly in view of the onerous requirement that 5 percent of bond proceeds be spent within thirty days of issuance. Furthermore, issurers and bond counsel have no guidance concerning the operation of many of these provisions. As indicated above, state law or increased cost of compliance with the provisions of the House bill have prevented many issuers from even going to the market.

The following are just a few examples of issuances that have been cancelled or postponed due to the uncertainty surrounding the provisions contained in H.R. 3838: the City of Louisville, Colorado for special improvement bonds for street paving; the Town of Wiggins, Colorado for drainage improvement; the Town of Silverthorne, Colorado for the construction of a new city hall; Johnson County Unified School District No. 229, Kansas for school construction; Wichita, Kansas for general municipal improvements; City of Hayes, Kansas for water supply improvements; the City of Great Bend, Kansas for flood control improvements; Pawtuckett, Rhode Island for various schools, streets and highways; Newport, Rhode Island for sewers; Bristol, Rhode Island for sewers; Alief Independent School District, Harris County, Texas for schoolhouse bonds. All of these are vital projects which were cancelled or delayed because of the complications of the January 1, 1986 effective date. Other issuers reporting difficulties or delays include Bonneville and Bingham School District No. 93, Idaho; State of New York; Granite School District, Utah; the State of Utah; City of Cheyenne, Wyoming; and Laramie County School District No. 2, Wyoming. Those few issuers who were able to issue bonds in January and February 1986 have been saddled with the increased cost of disclosure of the pending tax reform legislation. The uncertainty, chaos and risks of the tax exempt bond market surely will cause increased costs for those state and local issurers who issue bonds for vital needs in this period of confusion before enactment of tax reform legislation.

2. Section 401(k) Plans

Another significant concern of the NASACT membership is H.R. 3838's exclusion of state and local government employees' eligibility for Section 401(k) cash or deferred arrangements. The proposed exclusion is not only discriminatory and unfair, but it will have serious negative effects on state and local government's ability to provide vital services. At a time when the federal government is placing an increased burden on state governments to provide necessary services to the disadvantaged, it is conscionable for the federal government to inhibit state government from carrying out this responsibility.

A Section 401(k) plan is one of the many different kinds of retirement plans available to both public and private sector employees. H.R. 3838 would eliminate this as one of the options available in the public sector (though some previously existing plans have been grandfathered by the Bill). Under Section 401(k) an employee can designate a portion of his or her salary to be contributed to the plan. In many cases the employer can also match the employee's contribution. The benefit of such a plan is that there is federal income tax deferal on the amount contributed and also on amounts earned until withdrawal. The funds are fully taxable when they are withdrawn.

The advantages of a Section 401(k) plan are considerable. First and foremost is the security provided to the employee. A trustee is charged with the handling of the plan assets and the funds contributed by both the employee and the employer are not subject to the employer's creditors. The advantage to the state and local taxpayers is that use of Section 401(k) plans avoids the necessity for increased expenditures for "defined benefit plans." In general it has been found that Section 401(k) plans boost morale and lead to a more efficient work force. Last but not least, the availability of Section 401(k) plans puts the public sector on an equal footing and thus helps state and local governments to get and keep highly qualified employees.

The elimination of Section 401(k) plans for the public sector is totally unjustifiable. There is no rational basis for the discriminatory treatment of public and private sector employees. Elimination of this retirement vehicle would create poor morale among public sector employees. Certainly it is not the intent of the federal government to make public sector employees second class citizens with respect to retirement saving opportunities. In addition, the proposal contradicts the underlying tax reform philosophy -- instead of making a "level plain field," it creates new categories and disparate treatments. There is also concern with regard to the impact of this proposal on our federal system of government. It is certainly inappropriate, if not unconstitutional, for the federal government to prevent state and local governments from using an economically efficient means of compensation available to other employers. Such discrimination will only serve to make it even more difficult for state and local governments to "fill in the gap" left by decreased federal spending in the provision of social services.

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STATEMENT SUBMITTED TO U.S. SENATE FINANCE COMMITTEE

BY

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I appreciate this opportunity to submit a statement to the Senate Finance Committee on behalf of the National Association of State Treasurers regarding the tax exempt aspect of the pending tax bill.

Our Association is deeply concerned that the current provision under consideration places far reaching and unnecessary restrictions on the use of tax exempt financing.

Already as a result of the pending nature of this legislation and the effective date of December 31, 1985, we have witnessed a serious impact upon state and local governments' effort to issue tax exempt bonds.

I would say that while the effective date is of concern and has resulted in problems for the issuer and the market, we do not view a delay in the effective date as a solution or relief. From the standpoint of state and local governments we are not looking for a window of opportunity in the market in order to issue but rather an opportunity for the United States Senate to consider the serious impact of the legislation on the future of state and local government finance and our ability to meet the needs of our citizens.

I would hope that consideration would be given to the real purpose of the legislation and the actual and very real impact. If in fact the justification is to eliminate abuses, then honestly deal with that aspect, which can easily be done without jeopardizing the entirety of public purpose tax exempt financing.

I am concerned that many may view the issue of tax exempt financing as an issue of interest to a limited segment of our population referred to as "issuer and underwriter" and that both are some unsavory group preying upon the federal treasury. To take such a view and consider "issuer" as some nebulous special interest is to clearly lose sight of the fact that "issuers" are state and local governments representing the same people who elected members of Congress to represent them in Washington. The issuing of tax exempt bonds serve as a means to address public needs and to deliver public benefits.

Rather than considering to the fullest this aspect, the legislation in its current form represents a radical change from the current treatment of tax exempt status. While under existing law the emphasis is placed on the purpose of the financing, the new legislation places the emphasis on the status of the ultimate "user" of those proceeds. The definition of governmental versus non-governmental takes on a more restrictive character.

A bond is considered governmental under the House bill when no more than the lesser of $10 million or 10% of its proceeds is used for "nongovernmental" purposes, or no more than the lesser of $5 million or 5% of the proceeds is loaned to "nongovernmental" persons. If the bond does not meet both of these tests, it will be denied a tax exemption unless a specific exemption is provided. In addition, if nongovernmental use of a governmental bond exceeds $1 million but does not exceed the nongovernmental threshold, the portion over $1 million must be counted against the state's volume cap.

The 10% limitation applied to "governmental" bonds will pose serious problems for issuers of "governmental" bonds for public projects, especially when combined with the requirement that nongovernmental use exceeding $1 million in governmental bonds be counted against the state's volume cap. In many cases there is a significant private component to public works and buildings.

This change also creates a restriction that, if a use or user might change with a tax exempt financed facility, the bond character can change from governmental to non-governmental and subject the issue to additional restrictions as well as increased cost to the investor. The legislation also places a greater burden upon state and local governments to insure compliance and shifts from the current reasonable expectation or good faith rule to an "in fact" compliance. For example, an issuer although he has made every good faith effort to insure compliance, any accidental or incidental failure could cause the bonds to become taxable, retroactive to the date of issuance. Already we are seeing purchasers and investors demanding a premium for the assumption of this risk and thereby increased cost to the taxpayer.

By taking the unprecedented step of making a bond's tax exemption depend solely on the use of the proceeds rather than a predetermined category, H.R. 3838 imposes a tremendous recordkeeping burden and creates enormous uncertainty for issuers of governmental bonds. In order to insure that bond issues continued to qualify for a tax exemption, and to calculate the state's volume cap, state bond authorities would have to keep detailed records of the exact use of the proceeds of each tax exempt bond issue throughout the state---a task that would be burdensome, expensive, and extremely difficult, if not impossible. In addition, it would become difficult for bond counsel to issue an unqualified opinion on a bond issue, as their advice on an issue's qualification for tax exemption would necessarily be predicated on other issuances about which they have no control or knowledge.

Another restriction imposed on "nonessential function" bonds is the requirement that 100% of the proceeds be used for the bond's exempt purpose. Under current law, 10% of the proceeds of an IDB may be used for other purposes, such as the building of ancillary facilities which do not fulfill an exempt purpose. This flexibility to use a small portion of the proceeds to meet the various needs that may arise during the construction of a facility is often essential to allowing infrastructure projects to go forward.

In recent years state and local governments, in an attempt to more efficiently utilize their resources and to insure better management, have sought to involve the private sector in a number of public undertakings. Particularly in the area of solid waste disposal, privatization has become most attractive to state and local governments. Private sector involvement not only can produce cost savings but through management contracts, insure that the technical expertise is available. The overall effect of the pending legislation is to severely limit the potential for future privatization.

Under the legislation nongovernmental bonds eligible for tax exempt financing, with the exception of certain airport and port facilities, will be subject to an annual volume limitation in each state equal to greater of $175 per capita or $200 million. Because of the established set asides of the volume for particular purposes, the restrictive nature of the caps will eliminate many clearly defined public purpose projects. The effect upon housing, both single family and multi-family, could be very limiting.

A state by state analysis indicates that the proposed volume cap is clearly inadequate to meet demonstrated needs. Reductions mandated by the volume cap would be traumatic.

The fact that the cap is based upon a per capita basis fails to really consider the diversity of needs among the various states and local governments. While such a determination may appear fair and equitable, I do not think it recognizes the fact that infrastructure and other public needs in some states may be greater than others and the ability of those states to respond with their own capital resources may be limited. The inability to access the capital market in a cost efficient manner may realistically result in some of our poorer and least populated states being unable to make the significant investments necessary to meet their needs and encourage economic development.

With the cutbacks in federal funding and the limitation in capital access those states with limited tax bases may be destined to remain at a level that denies them participation in the nation's economic prosperity. This is indeed a concern in my own state of Mississippi.

At present, banks may deduct 80% of interest paid on borrowing used to carry tax exempt bonds. Under the pending legislation that deductability would be eliminated.

While some may view this particular provision as a means to eliminate a tax loophold for the bank and force banks to pay taxes on such transaction, the actual effect will be to eliminate banks from the tax exempt marketplace. The generation of revenue is inconsequential.

This is particularly of concern to those states where bank purchasers of local government bonds is the major market for such financing.

In Mississippi for example, the majority of our political subdivisions are unrated. Their access to capital is limited to local banks and regional banking institutions. The fact that these banks are removed from the market creates in reality a removal of access to the market for these local governments.

We have already seen the impact of this in Mississippi, with several of our school districts unable to obtain bids on their bonds as a result of the withdrawal of this market. In many states small security dealers who deal with local banks and the local banks themselves provide the structure for marketing small issues. The elimination of this structure by this provision effectively destroys the ability of many local governments to finance needed public purpose projects.

The limited exemption in the House legislation is not satisfactory. Many technical questions exist as well as concern that the exemption is not permanent. The exemption contained in the legislation is available only in instances where the bank is in the state of the issuer. That creates severe problems for those local governments which border other states and have established relationships with banks in the other states or regional banks.

The legislation contains severe restrictions on arbitrage and early issuance which are not only costly to state and local government but unworkable.

From the standpoint of state and local governments we are concerned about a number of these restrictions.

First, the requirement that 5% of the proceeds of an issue must be expended within 30 days. This requirement has already caused a disruption in the ability of state and local governments to issue because of an impossibility of complying with this requirement. The simple fact is that such a restriction is unrealistic and government, because of purchasing and contracting laws, cannot comply. The answer does not lie in changing those contracting procedures. No state or local government desires to commit legally to the expenditure of funds for a project and then have for one reason or not an anticipated bond financing be delayed or fall through. Such a practice is not the answer for complying with this restriction.

Second, the requirement that all arbitrage earned on invested funds be rebated unless all bond proceeds are spent within six months from the date of issuance.

Third, the elimination of the ability to include the cost of issuing bonds in determing the allowable earnings.

Fourth, the limitation on temporary periods during which arbitrage can be earned.

Fifth, the elimination of the minor portion exemption under current law will require issuers to rebate all excess earnings including reserve funds or invest at the net borrowing cost excluding the issuance cost. This will affect the size of reserve funds in the future and thus affect the marketability and economic viability of the issue because of the importance of such reserve funds.

We also would express our concern with the new restriction regarding refundings which serve as an effective and cost efficient debt management tool of state and local governments. Here again the legislation fails to consider the actual public purpose involved by restricting advance refunding to governmental bonds only. This fails to recognize the benefit of refunding in areas which may be non-governmental according to the bill but tradionally viewed as public purpose. A prime example is hospitals where concern for cost containment makes the opportunity for advance refunding of debt an important consideration. In fact, the inability to refund hospital related debt could result in increased health care cost to the public as well as the federal government.

The restriction on advance refunding is further complicated by the fact that the bill specifies that advance refunding of bonds issued before the effective date of January 1, 1986 will qualify only if that issue would be governmental under the new rules. In order to advance refund pre 1986 bonds, issuers will have to go back and attempt to trace in detail the exact use of the proceeds. In addition, advance refunding would be subject to the volume cap to the extent that the amount attributable to any nongovernmental use of the refunded bonds exceed $1 million. There is also a need for clarification to prevent these restrictions from applying to variable rate demand bonds and other traditional short term financing.

These new restrictions which represent a radical departure from current law and traditional concepts operate to complicate state and local debt management to the point of inefficiency and ineffectiveness.

I am concerned that many small and infrequent issuers may not have the financial management sophistication that will be required in order to comply. As a result they bear the burden of risk in having their bonds declared taxable and must either determine to not run the risk and exclude themselves from the market, be forced from it, or pay investors a premium for participation. Neither prospect is in the best interest of the taxpayers.

A great deal of discussion and study in the past few years has centered on the decaying infrastructure of the nation and the need for infrastructure investment and development.

Infrastructure investment and development serves as the life support system of our economy and provides the foundation for economic efficiency and growth.

The magnitude of needs is tremendous. Every level of government recognizes this and the importance of meeting these needs, yet their abilities to do so are becoming more limited.

A February 1984 study prepared for the Joint Economic Committee of the Congress has determined that it would take over $1.1 trillion dollars between 1983 and the year 2000 to address the infrastructure needs in four areas: highway and bridges, other transportation, water supply and distribution, and wastewater collection and treatment. The Government Finance Research Center declares that state and local governments must spend $95.9 billion a year to assure adequate levels of service in essential infrastructure categories.

Gramm-Rudman will have the effect of more significantly placing greater financing responsibilities on state and local governments. At the same time that there is a shifting of responsibilities, the Congress is also considering a tax bill with provisions which will severely limit state and local governments from using the tools previously available to meet these demands.

Tax exempt financing has served state and local governments well as a cost efficient means for infrastructure and economic development. It should continue to be available as an effective means of meeting these needs.

State and local governments recognize the need for fiscal restraint at the federal level and a reduction in the deficit. We support the concept of new federalism.

However, a desired policy of new federalism should not become a game of mirrors and blue smoke, when using the mirrors of Gramm-Rudman and fiscal restraint we shift financial burdens to the states and then with the smoke of tax reform we restrict a state's ability to deal with it.

The Congress and the federal government simply must be consistent in its approach.

The Private Sector Advisory Panel on Infrastructure Financing to the U.S. Senate Committee on the Budget, which has been charged by Senator Domenici to examine infrastructure needs and financing alternatives, has concluded that many of the pending provisions of the tax bill will adversely impact infrastructure investment and development.

If we recognize infrastructure development as a national policy objective necessary for economic growth, then the tax reform bill should be consistent with that policy and serve to encourage and promote infrastructure development rather than impede.

State and local governments are being presented a time bomb colorfully wrapped in new federalism, Gramm-Rudman, and tax reform.

It seems that the satisfaction of some in this attempt is the hope that when the explosion goes off the blame will be placed on state and local governments.

I would hope that the consideration of this legislation by the United States Senate will center on the impact upon the taxpayer, recognizing that the same person that pays federal taxes also pays state and local taxes, and the impact upon public needs which are recognized as national public policy and which must be met by some level of government.

The provisions of this legislation regarding tax exempt financing is the wrong legislation for the wrong reason. It accomplishes little but complicates much unnecessarily.

The linkage of tax reform with tax exempt financing in reality is to confuse both. Tax exempt financing for public purposes does not represent part of the problem but it can be part of the solution for state and local governments in meeting the increased responsibilities placed upon them. To enact this legislation as currently written serves not as a denial to state and local governments but is a denial of prosperity and an improved quality of life to people of the nation.

I firmly believe that it is possible to maintain fiscal responsibility as well as a responsibility to the future. This legislation as drafted does neither. I trust that the Senate will allow state and local governments to effectively and efficiently manage their fiscal affairs, promote economic growth, and meet the needs of the people of these United States.

While I do not accept the Treasury Department figures, the fact that tax exempt financing does result in certain tax losses to the federal treasury must be viewed in the context of the declared public policy sought to be promoted through the use of tax exempt financing by state and local governments. I would submit that due to the magnitude of the need for infrastructure development and its importance to economic growth that such "cost" or loss of revenue is mitigated by the fact that it would seem to be a reasonable expenditure of public funds for a declared public purpose.

With regard to the legislation pending we would offer several suggestions for consideration.

1. The limit on nongovernmental use of facilities financed with governmental bonds should be raised to 25% as is the case under current law, and the rule requiring inclusion in the volume cap of nongovernmental portion of governmental bonds that exceed $1 million should be deleted.
2. The volume cap should be enlarged to provide more realistically for the needs it is designed to cover.
3. The proposed changes in arbitrage rules should be rejected and current law retained. As drafted, the pending changes are both complicated and unworkable. In particular, the 5% early issuance rule should be eliminated and temporary period provided in a workable and realistic manner. Delete the rebate requirement. Return to the reasonable expectation rule.
4. Maintain the present law regarding deductibility of interest paid on bank borrowing to carry tax exempt bonds. Or in the alternative, make the exemption of $3 million permanent and extend it to include any bank having assets of $500 million.
5. Permit advance refunding of nonessential function bonds. Define non-advance refunding realistically to allow time to redeem prior bonds. Provide that no portion of advance refunding will be subject to the volume cap. Eliminate the look-back provision that pre-1986 bonds must qualify as governmental in order to be eligible for advance refunding.

NATIONAL ASSOCIATION OF TAX ADMINISTRATORS
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AN ANALYSIS OF THE IMPACT ON STATE AND LOCAL GOVERNMENTS OF SECTION 145 OF H.R. 3838, THE TAX REFORM ACT OF 1985

PREPARED BY THE NATIONAL ASSOCIATION OF TAX ADMINISTRATORS
FOR THE SENATE FINANCE COMMITTEE HEARINGS ON TAX REFORM
January 29 - February 6, 1986

The National Association of Tax Administrators, an organization of the state tax agencies of the 50 states and the District of Columbia, expresses its appreciation to the Senate Finance Committee for its invitation to submit a statement on Section 145 of H.R. 3838, the Tax Reform Act of 1985.

The state tax agencies are gravely concerned over Section 145 because it contains requirements which the state and local governments cannot comply with, which would result in state and local costs in excess of any benefits that would accrue to the federal government, and which call upon state and local governments to provide the federal government with voluminous information, much of which the Internal Revenue Service could not use.

Section 145 was not included in the President's Tax Reform Program and no hearing was held on its provisions before it was included in H.R. 3838, the Tax Reform Act of 1985.

Section 145 Requirements

Section 145 imposes two requirements on state and local governments:

(1) State and local governments would be required to report to the federal government the amount of income and property tax payments of $10 or more received from individuals during the past calendar year. The Secretary of the Treasury would prescribe the forms and regulations relating to the federal returns.

(2) State and local governments would also be required to furnish a written statement (a Form 1099 or its equivalent) reporting the same amount to individuals paying income and property taxes. This statement would have to be furnished to the taxpayer during January following the calendar year for which the return to Treasury was made.

The two requirements are unrelated except they are concerned with the same taxpayers and the same amounts. The first requirement--the filing of an annual report with the Secretary of the Treasury--is designed to provide the Internal Revenue Service with information which would permit verification of deductions claimed by federal taxpayers for state and local taxes paid. The second requirement--the furnishing of Form 1099s to taxpayers--is designed to assist taxpayers in reporting their state and local tax deductions accurately on their federal tax returns.

Both objectives are desirable. However, under state and local laws, and with respect to the ability of employers and taxpayers to furnish tax information, most of the requirements of Section 145 cannot be fulfilled.

As to the first requirement, for reasons to be discussed later in this statement, the Internal Revenue Service will not be able to use the information in the reports on property tax payments provided by state and local governments. As to the second requirement--furnishing taxpayers with written statements showing their income and property tax payments--a great majority of state and local governments will be unable to provide such information in the form or at the time Section 145 would require.

Section 145 in its present form would automatically make state and local governments unintentional violators of federal law because they could not physically comply with the federal requirement. Their attempts to do so would generate a massive amount of paperwork and data processing, much of which would serve little constructive purpose because the information could not be used either to facilitate or confirm the accurate reporting of state and local deductions taken on federal tax returns.

Feasibility of Section 145 Requirements

Income Taxes

Section 145 calls for the reporting of income and property tax payments received by state and local governments during the past calendar year. As previously noted, information on these payments is to be reported to (1) the Treasury and (2) taxpayers in the form of a 1099.

For income taxes, the reported payment would apparently consist of (1) the amount of taxes paid on the annual income tax return filed during the calendar year (for the preceding tax year), (2) taxes withheld during the calendar year and reported on W-2s after the close of the calendar year, and (3) estimated taxes actually paid during the calendar year.

The following relates to the feasibility of these requirements.

For the report to be filed with the Secretary of the Treasury: It is probable that no state or local government currently maintains tax return information on a basis which combines these three forms of tax payments. For many states, if not most states, it would require as much as a year to prepare each annual report combining these tax payments. It should be noted, however, that in many cases, the state-reported data will not conform to the taxpayers' federal tax returns because, as an example, estimated taxes paid by the taxpayer at the end of December may not be received by the state until the next calendar year.

It may also be noted that this is the type of information the states have provided the Internal Revenue Service through the 60-year-old Federal-State Exchange Program. They have furnished such information voluntarily and with no Congressional mandate to do so.

For the Form 1099s to be furnished the taxpayers:

(1) It is not operationally possible for state and local governments to furnish a Form 1099 to the taxpayers in January showing payments received during the preceding calendar year. Nor is it possible to visualize any modification of the requirement or any modification of state procedures which would make the requirement feasible. For most states, the due dates for W-2s (reporting withholding taxes on wages) falls between January 31 and February 28. The state due dates could not be advanced to accommodate the Section 145 January reporting requirement. This is because most employers could not meet a W-2 filing due date before the last week in January. For those who could, the states could not process the information received in mid-January for transmittal by the end of the month.

If Section 145 were to set a later date for furnishing the Form 1099 to the taxpayers, it would defeat the purpose of the requirement since many taxpayers would receive this information after they had already filed their federal tax returns.

(2) Although Section 145 provides that a Form 1099 is not required for individuals "who will not claim itemized deductions," it appears that state and local governments would have to furnish 1099s to all taxpayers since they would have no way of knowing in January whether the taxpayer would or would not itemize on his federal tax return due in April.

(3) Since more than 60 percent of the taxpayers do not itemize, and this percentage will rise if the tax reform bill becomes law, a

large majority of the Form 1099s and the returns made to Treasury would relate to nonitemizers and would have no value either to the taxpayer or to IRS.

(4) State tax agencies have strongly questioned the reason for including in Section 145 a provision calling for both reports to the Treasury on income tax payments and Form 1099s to taxpayers showing such payments. They point out that IRS can match the Treasury reports against the deductions claimed by the taxpayer and through this method discover taxpayer over-reporting. If adequate time was allowed, this could be accomplished without the problems of feasibility and the huge costs associated with the furnishing of Form 1099s. The state and local governments also suggest that improved compliance in the reporting of state and local tax deductions could be accomplished through a more extensive explanation of state and local tax deductions in the instructions for Form 1040.

(5) As has already been noted, many taxpayers file their state declarations of estimated tax on the last days of the calendar year in order to qualify such payments as deductible for federal tax purposes. Such payments would not be received by the taxing state until the following calendar year; thus, the state-furnished information would not correspond to the deductions taxpayers reported on the federal tax return.

Property Taxes

For property taxes, the requirements of Section 145 are not operationally feasible as to either the report to the Treasury or the Form 1099 to be furnished to the taxpayer. The principal reasons are as follows:

(1) Property taxes are levied against the property rather than the owner. It is probable that few jurisdictions require that a social security number be reported with the tax returns. In the absence of a social security number, the property tax payment information would have no value for IRS since they could not be matched against the taxpayers' returns.

(2) Since the property tax is against the property rather than against the owner, the taxing jurisdiction could not readily identify the taxpayer in instances of ownership change and in instances where the ownership may be joint or in the name of an unincorporated business or a trust.

(3) Since property taxes may be paid in December, the taxing jurisdiction would have difficulty in processing this information in time to provide 1099s in January. Also, since property tax payments made in December may not be received until January, the 1099 required by Section 145 may differ in amount from the deduction taken on the taxpayer's federal return.

(4) A substantial number of small local governments do not have the computer facilities to meet the requirements of Section 145.

Cost of Compliance

For the reasons described above, state and local governments are unable to comply with principal requirements of Section 145. However, even if they could do so, their cost of complying would be so large as to question the justification for Section 145 requirements. The response to an NATA survey, now in process, shows that the state and local governments' cost of complying with Section 145 would far exceed the revenue benefits to the federal government.

Information received from 25 states thus far indicate that for state and local governments combined, the annual cost of complying with Section 145--postage and processing expense--would substantially exceed $62 million, the amount the Joint Committee on Taxation staff has estimated as the annual yield to the federal government from Section 145. (This estimate is discussed later in this statement). If there is added to this amount state and local revenue that would be lost because of funds transferred from revenue-producing enforcement activities to Section 145 compliance requirements, we must consider a potential state and local revenue loss in the hundreds of millions of dollars. State audit experience indicates that for each dollar spent on auditing, the states receive as much as seven or eight dollars per dollar spent on auditing.

Examples of the costs to the states are the following:

California estimates that, for income taxes alone, the annual cost for complying with the reporting and the Form 1099 requirements would amount to $4.6 million; the property tax requirements would add $8.7 million annually for a combined total of $13.3 million.

In Arizona, combined annual expense would be nearly $4 million and in Illinois and Virginia, more than $9 million.

Florida, which has no personal income tax, would incur $2.7 million in annual expenses related to the property tax requirements.

South Carolina reported that Section 145 would result in direct state costs of $600,000 and indirect costs of $4.2 million due to the diversion of enforcement funds.

The combined income tax and property tax expense would approximate $1.75 million in Colorado, $1.1 million in Louisiana, and $1.4 million in Mississippi. Oregon's costs, for income taxes alone, would total $760,000.

It may be noted that for the ten states discussed above, the Section 145 compliance costs would exceed $43 million annually, and this amount would constitute only a fraction of total state and local compliance costs. Each of the states thus far responding to the NATA survey reported that while the high compliance costs were a major concern, in practical fact, the Section 145 requirements could not be complied with. NATA would be pleased to make state-by-state information available to the Senate Finance Committee upon completion of the survey.

Benefits to the Federal Government

The Congressional Joint Committee on Taxation staff has informed NATA that, according to its estimates, Section 145 would produce $139 million over a three year period as follows:

FY 1988 - $30 million
1989 - 47 million
1990 - 62 million

This data suggests that state and local governments would have to bear extremely high costs (expense and revenue loss) in order to produce an amount of federal revenue which is relatively small when compared to these costs.

There is also a question as to whether the federal estimates should be reduced because of the technical problems which would prevent the use of much of the information sought by Section 145.

IRS Data on State and Local Tax Deductions Show A High Level of Accuracy

State and local governments question the reason for the difficult and costly Section 145 requirements when Internal Revenue

Service data show that taxpayers report state and local deductions with a high degree of accuracy. The results of an IRS Taxpayer Compliance Measurement Program published in April 1985 show 90 percent of itemizing taxpayers either reported their state and local income tax deductions accurately or claimed smaller deductions than they should have. Only 7 percent of itemizing taxpayers overstated these deductions by more than $50.

The IRS TCMP data show that other types of deductions are much more likely to be overstated. As examples, 21 percent of taxpayers claiming a deduction for interest paid (other than home mortgage interest) overstated the correct amount by more than $50, and 26 percent of those claiming deductions for charitable cash contributions overstated the correct amount by more than $50.

Summary

In summary, Section 145 would have an adverse impact on state and local tax administration and enforcement for the following reasons:

(1) It would impose major new compliance requirements.

(2) Some of its principal requirements are not operationally feasible, a factor which would unintentionally place state and local governments in violation of federal law and which would render much of Section 145 ineffective.

(3) Financing the requirements would divert state and local funds from revenue-producing enforcement activities to expenditures which produce no state or local revenue.

(4) The cost of postage, processing, and restructuring computer operations and the revenue loss due to the diversion of enforcement funds would be extremely high.

(5) Estimated federal revenue attributable to Section 145 is substantially less than the estimated direct and indirect costs to the state and local governments.

(6) A large part of the information state and local governments would be required to furnish the federal government and the taxpayer would have no value either in discovering unpaid taxes or in promoting accurate filing since such information would either not be relevant or there would be no means for relating this information to state and local taxes deducted on federal tax returns.

(7) The Internal Revenue Service has conducted studies which indicate a high degree of accuracy in taxpayers' reporting of state and local tax deductions.

(8) For income tax purposes, the intent of Section 145 to diminish federal tax evasion can be accomplished by matching programs developed through the use of information the states can furnish to the Internal Revenue Service. A strong argument can be made that the enforcement benefits obtainable from the use of this information obviate the need for the large costs and major problems

attributable to the Form 1099 requirements. These enforcement benefits could be coupled with improved instructions on the federal tax form assisting the taxpayer in determining the amount of state and local taxes deductible in any tax year.

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STATEMENT

by

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on

FEBRUARY 20, 1986

submitted to the

SENATE FINANCE COMMITTEE

on

THE TAX REFORM ACT OF 1986, S. 1786

INTRODUCTION

As one of the oldest and largest non-profit membership organizations devoted to resource conservation, the National Audubon Society appreciates this opportunity to present its views on the agricultural aspects of the Tax Reform Act of 1986 as contained in S. 1786, introduced by Senators Boren and Grassley on October 23, 1985.

One major focus of National Audubon Society programs is on traditional concerns for the well-being of our native plants and animals, particularly endangered, migratory, and non-game species of birds and other animals. Cropland, pastureland, and rangeland constitute important habitat for many of these species. Recent federal policies and programs have increased consideration of wildlife habitat and conservation objectives, such as water and soil conservation. The Food Security Act of 1985 integrated conservation with the basic farm programs for the next decade. We think these goals are compatible and can be pursued simultaneously with benefit to society at large.

The National Audubon Society supports S. 1786, The Cultivation of Highly Erodible Lands and Wetlands Tax Act, because it believes that the tax code should not reward activities which damage the environment. Currently the federal tax code makes agriculture an inviting tax shelter. Investment tax credits, deductible "conservation expenditures," accelerated depreciation, and capital gains benefits too often subsidize the conversion of rangeland to irrigated cropland in inappropriate locales and terrain by as much as $180 per acre. By distinguishing between harmful and beneficial practices, S. 1786 would in effect halt the subsidization of activities which are detrimental to designated natural areas.

S. 1786 eliminates those provisions in the tax code that in effect encourage exploitation of highly erodible land and wetlands. The bill repeals credits and deductions resulting from the conversion of highly erodible lands and wetlands. It also treats gains from the sale of highly erodible lands and wetlands as ordinary income, not capital gains.

The tax incentives addressed by this bill were originally enacted in order to spur development and harvest resources, activities considered in the public interest. However, "fencerow to fencerow" planting in the seventies expanded on to wetlands and highly erodible lands. This led to an accelerated decline in the number of wetland acres and a dramatic increase in soil sedimentation and wind erosion from our eroding croplands. In recognition of the the seriousness of these developments, Congress included the "Swampbuster" and "Sodbuster" provisions in the Food Security Act of 1985. The Act's conservation title denies federal farm program benefits to farmers who convert wetlands or bring highly erodible land into crop production. S. 1786 compliments the Farm Act by removing current tax incentives for the conversion of ecologically fragile lands, conversion that makes no sense at a time when record commodity surpluses and historically low prices are plaguing the agricultural sector of our economy.

Our testimony now turns to a discussion of the importance of removing the tax incentives that promote agriculture development on fragile lands. The following section addresses other aspects of S. 1786 and the problems it is intended to solve. Finally, suggested changes to the bill are offered to encourage taxpayers to conserve ecologically fragile lands to a greater degree.

WETLANDS

The definition of wetlands in S. 1786 will conform to the language adopted by the Food Security Act of 1985 and the House-passed Daub-Dorgan amendments to the Tax Reform Act of 1986. Wetlands are places where the "Land has a predominance of hydric soils and is inundated or saturated by surface or groundwater at a frequency and duration sufficient to support...a prevalence of hydrophytic vegetation typically adapted for life in saturated soil conditions." This definition includes swamps, marshes, bogs, and similar areas such as sloughs, potholes, wet meadows, river overflows, pocosins, mudflats, and natural ponds.

Wetlands provide food and critical habitat for a wide variety of aquatic, avian, and terrestial species. Approximately two-thirds of the major U.S. commercial fishes depend on estuaries and salt marshes for nursery and spawning grounds. These include menhaden, bluefish, fluke, sea-trout, mullet, striped bass, and many salmon species.[1] Coastal wetlands are also essential for shellfish such as shrimp, blue crab, clams, and oysters. Like their saltwater relatives, freshwater fishes are also dependent upon wetlands for food, nursery grounds, and spawning.

Birds also rely on wetlands for their well-being. Resident birds can be found foraging for food in wetlands from coast to coast and wetlands provide migratory birds with important nesting, feeding, and resting areas. Ducks, geese, shorebirds, and wading birds are just a few of the birds that live in the wetland environment. The importance of wetlands cannot be overstated. Some 119 species of birds rely on North Dakota's potholes as do 80 percent of the ducks raised within the U.S. borders.[2] One quarter of the continental mallard population spends the winter in the lower Mississippi Basin. However, this region is where 200,000 acres of bottomland hardwood wetlands have been converted to row crops each year.[3]

Ask any fur trapper and he can tell you that beaver, muskrats and nutria inhabit coastal and inland marshes throughout the country. Other mammals that utilize wetlands include otter, mink, raccoon, skunk, and weasels.[4] Reptiles and amphibians including alligators and crocodiles, turtles and snakes, and frogs and salamanders are also indigenous to our wetlands. Moreover, 20 percent of all plants and animals threatened or endangered depend on wetlands for survival.

Besides providing homes for fish and wildlife, wetlands play an important role in maintaining high environmental quality. Wetlands remove excess nutrients in their waters which helps to prevent eutrophication. They are excellent filters of waste products from water. Wetlands store and convey floodwaters. This reduces turbidity, flooding frequency, and peak flood levels downstream thus cutting down on the amount of flood damage. William T. Mitsch of the Illinois Institute of Technology recently calculated the value of a 74 acre swamp along the Cache River in sourthern Illinois. By holding floodwaters and absorbing nutrients, he found the swamp saved $18,000 a year for the local municipalities.[5] Finally, wetlands are invaluable for groundwater recharge and discharge. In Massachusetts, for example, 40-50 percent of wetlands may be potential sources for drinking water.[6]

Wetlands are also a valuable recreational resource. Hunters and fishermen spend billions of dollars each year to capture wetland dependent animals and fish.[7] Other recreation in wetlands is non-consumptive and includes hiking, swimming, photography, birdwatching, and even ice skating! While aesthetics are hard to pin a dollar value on, 47 percent of all Americans demonstrated an active interest in wildlife near their homes in 1982 and many consider wetlands as priceless entities.[8]

Yet, despite the undisputed value of wetlands, they continue to disappear at a staggering rate. In the most comprehensive study to date of wetland losses, the U.S. Fish and Wildlife Service has estimated that, on average, nearly one-half million acres of wetlands are drained or filled and converted to other uses every year in the conterminous United States.[9] During the 20-year period of study, the Service estimated that over nine million acres of wetlands were lost. This equates to an area about twice the size of New Jersey. Over 85 percent of this recent wetland loss was from agricultural development.[10] Overall, 62 percent of the Southwest Pacific coastal marshes, 87 percent of the estuarine wetlands in the Northeast, and two-thirds of the bottomland hardwoods have been destroyed or degraded.[11]

Examples of wetland destruction come from all parts of our nation: red maple swamps and black spuce bogs of the northern states, salt marshes along the coasts, bottomland hardwood forests in the Southeast, prairie potholes in the Midwest, playa lakes and cottonwood-willow riparian wetlands in the western states, and the wet tundra of Alaska. In one specific case, 800,000 acres of scrub-shrub wetlands called "pocosins" in North Carolina have been converted, in the past 50 years, much to large-scale agriculture. While the remaining "pocosins" still encompass one million acres, runoff from the farmlands has degraded water quality of adjacent estuaries and caused nutrient loading and changes in salinity.

Federal initiatives to protect wetlands do exist. In an ongoing process, the Fish and Wildife Service currently has mapped wetlands on 40 percent of the conterminous United States. Executive and legislative intent to preserve these valuable resources is manifested by Executive Order 11990 "Protection of Wetlands" and §404 of the Clean Water Act. Section 404 requires the issuance of a permit from the U.S. Corps of Engineers for the discharge of dredged and fill material into waters of the United States, including wetlands. However, in many cases, agricultural activities are exempted when the wetland is being brought into a "new" use.

The Water Bank Program, administered by the Agricultural Stabilization and Conservation Service of USDA, aims to preserve and improve wetlands as habitat for migratory waterfowl. The Water Bank makes no outright acquisitions. Instead, it enters into contracts with farmers to preserve wetlands and adjacent uplands. When a person enters a contract, he agrees not to burn, drain, fill, or otherwise destroy the wetland. In return, he receives an annual payment. In 1982 the program was appropriated a much smaller amount of funds, an amount that made it impossible to renew most of the contracts. The current funding for the Water Bank Program has been proposed to be rescinded and no new contracts are being entered.

Several other federal laws and policies provide some protection for wetlands, including the Fish and Wildife Coordination Act and the Coastal Zone Management Act. But the yearly destruction of wetlands continues largely because the government deviates from its stated intent to protect wetlands by providing tax incentives for agricultural development of these areas. According to the Office of Technological Assessment (OTA), "tax deductions and credits for all types of general development activities provide the most significant federal incentive for farmers to clear and drain wetlands."[12]

Studies of the effects of tax incentives have been completed by Ralph E. Heimlich of the Economic Research Service. In an unpublished report based on representative farm models, he finds that, "[d]eductions of land clearing and drainage costs, accelerated cost recovery of drainage tiles and other depreciable land improvements, and capital gains treatment provide subsidies for agricultural conversion of wetlands that help to offset fixed conversion costs by $11 to $133 per acre. He continues, "[s]uch provisions may attact investments in land conversion by non-farmers with income from other sources to shelter."[12] It is clear that federal tax policy provides many of the incentives that are causing the destruction of these valuable lands.

S. 1786 would eliminate incentives for conversion of wetlands by removing capital gains as well as credits and deductions incurred by developing wetlands. Moreover, this tax code reform would help reinforce the "Swampbuster" provisions in the Omnibus 1985 Farm Bill. Passed on December 23, 1985, the Food Security Act denies federal program subsidies to people who convert wetlands to crop production. Without changes in the tax code, farmers will face contradictory legislative policies: the Farm Bill which urges conservation, and the current tax code, which encourages wetland exploitation. S. 1786 also would affect those farmers who produce non-program crops such as soybeans and tomatos primarily for tax benefits.

HIGHLY ERODIBLE LAND

The Food Security Act also recognized our nation's soil as a vital resource. In the Act, government subsidies are denied to farmers who develop highly erodible lands. While national rates of conversion of highly erodible land are not available, from 1974 to 1982 420,000 acres of high erodible land were converted in South Dakota. In Colorado, 572,000 acres of highly erodible land were plowed up from 1978 to 1983.[13] The 1985 Farm Act sets a precedent in determining that encouraging the cultivation of highly erodible lands is inappropriate government policy, particulary when crop surpluses are on the rise.

The definition of highly erodible lands in the Omnibus Farm Bill of 1985 and the House-passed Daub-Dorgan amendments of the Tax Reform Act of 1986 are determined by the Soil Conservation Service of the United States Department of Agriculture. Highly erodible lands are those of class IVe, VI, VII, and VIII under the land capability classification system, or land that would have an excessive average annual rate of erosion in relation to the soil loss tolerance level as determined by the Secretary of Agriculture through the application of factors from the universal soil loss equation and the wind erosion equation. Class IVe land is defined to have severe limitations that reduce the choice of plants and require very careful management. Class VI, VII, and VIII land is unsuitable for cultivation of crops without comprehensive management systems.

The harmful effects of cultivating highly erodible land include soil sedimentation and wind erosion. The House Agriculture Committee found that, "[s]oil erosion and water runoff are often blamed for a variety of damages that occur when soil sediment, fertilizer nutrients, and pesticides are washed from farm fields into streams, drainage systems, lakes, reservoirs, or other vulnerable areas. Sediment damage is generally viewed as the most serious off-site problem caused by soil erosion. For instance, the sediment resulting from erosion is undoubtably costing the nation billions of dollars a year as it fills up valuable reservoirs, increases the frequency and seriousness of floods, clogs navigational facilities and canals, interferes with industrial hydraulic equipment, increases the cost of treating drinking water supplies, destroys valuable aquatic wildlife, and substantially diminishes the recreational potential of downstream waters. The nutrients, pesticides, and other contaminents carried into waterways with the eroded soil exacerbate all these problems and create still others." [14]

The cost of all non-point source pollution in 1980 was estimated to be 6.1 billion dollars. Of this total, 2.2 billion dollars were estimated to come from cropland erosion.[15] These are totals of actual expenditures occuring in combating nonpoint source pollution and do not include the long term costs of lower productivity of our nation's farmland.

The damage from wind erosion is also severe. Desertification and productivity losses are two long-term effects, but in the short run dust storms lower visibility, fences are rendered useless due to deposits of wind-blown soil being deposited downwind, and even farm machinery is damaged. Additionally, wind-blown soil deposited on rangeland quickly suffocates native vegetation and promotes Russian Thistle and other unwanted annuals. Finally, many feel wind erosion is likely to get substantially worse. W.A. Laycock from USDA reports, 'Many fear that even a period of even moderate drought will result in soil erosion and dust storms of major proportions from the newly plowed areas that expose erodible soils." [16]

Presently, there is pending legislation that seeks to alleviate the off-site damages of soil erosion. A proposed amendment to the Clean Water Act would call for states to develop programs to identify and combat nonpoint-source pollution problems. Should a state find a federal program subsequently at odds with its own, steps may be taken to remedy the inconsistency. The problem is that participation by a state in the program is optional--states are not required to impose abatement measures unless they participate in the program, allowing federal tax incentives that foster poor soil use to continue unabated by state action.

There is little other legislation aimed at regulating the development of highly erodible land and the nonpoint source pollution and losses in future productivity it promotes. There is no doubt, however, that our tax code leads to the development of these lands through capital gains benefits at the time of sale, as well as the many credits and deductions to offset the direct costs of conversion. Edward Anderson, Master of the National Grange, reported, "The Internal Revenue Code has more affect on the status of American Agriculture than the federal farm programs."[17] Unfortunately, many operators complete the conversion of range without any regard to commodity programs because their intent is to "farm" the tax code, not the land.

One well-known example of tax-code initiated development of highly erodible land is in Weld County Colorado. From 1979 through 1982, 45,000 acreas of highly erodible rangeland was converted into cropland. This development has caused depletion of water tables, increased siltation of nearby streams and rivers, and staggering wind-erosion soil losses. Local farmers did not participate very much in this development. Instead, investors interested in sheltering large non-farm incomes were the main contributors. These investors accelerate erosion problems according to studies by the University of Missouri and Ohio State University because, "Land owned by those most able to exploit the tax code is generally less-protected from soil erosion than land held by family-sized farmers."[18] Farmers who cultivate the land they own tend to be the most conservation-minded stewards.

S. 1786 would eliminate incentives for investors and farmers alike to plow up highly erodible lands like the ones in Weld County. By removing credits, deductions, and capital gains, S. 1786 compliments the "Sodbuster" provisions in the Food Security Act of 1985. S. 1786 also eliminates incentives to farmers who develop marginal land and who do not participate in federal farm programs or who produce non-program crops. These farmers are not affected by the disincentives in the Farm Act. Instead, they are only encouraged to develop land by the federal tax incentives.

OTHER FEATURES OF S. 1786

Developers buy fragile land, convert it, and sell it as developed land for higher prices. Several tax incentives encourage this trend. Investment tax credits reduce the initial after-tax price of the land while capital gains exemptions exclude sixty percent of the gains from taxation. S. 1786 would amend the Internal Revenue Code of 1954 by treating the gains from developing highly erodible land and wetlands as ordinary income. This has the effect of raising the breakeven price at which investors have to sell the fragile lands. Demand is reduced at these new higher prices, resulting in less fragile land being developed. Since capital gains still apply to prime farmland, development of good land is not hindered. Treating gains as ordinary income makes fragile land development less attractive to "tax loss" farmers who generate after-tax profits under market conditions that entail losses for more traditional farmers.

Another tax advantage that farmers are now allowed to use is the deduction for "conservation expenditures." According to the section 175 of the tax code, the activities that qualify for these deductions include, "Moving of earth including (but not limited to) leveling, grading, and terracing, coutour furrowing, the construction, control, and protection of diversion channels, drainage ditches, earthen dams, watercourses, outlets, and ponds, the eradication of brush, and the planting of windbreaks."[19] Many of these activities do not reduce actual soil and water loss, but often merely serve to increase production on a parcel of land. One example of the abuse these "conservation expenses" occurs in the Sandhills region of Nebraska where some farmers have bulldozed ridges to enable cultivation equipment to pass over the fields. The destruction of grass cover and the exposure of the light soil to the ravages of wind erosion have resulted. Similar deductions have been applied to the filling of prairie potholes which interfere with the convenience of farm machinery.

S. 1786 eliminates all credits and deductions incurred in converting highly erodible lands and wetlands unless the conversion is exempted under the exceptions in the bill. One exception is fragile land under a conservation system, approved by the SCS according to their technical standards. Conservation systems require the application of useful soil and water conservation practices, practices that are judged by the SCS by their ability to conserve soil and water. By requiring conservation systems on fragile lands in order to retain credits and deductions, fewer deductions of improper "conservation expenditures" are likely.

Elimination of improper applications of section 175 as well as capital gains on the land that has been converted from highly erodible land and wetlands, enhances Treasury revenue. No estimate has been made on the Revenue created by the specific provisions of S. 1786, but previous estimates calculated under different criteria estimated the increased revenue to be from \$300-\$800 million dollars a year.[20] This new revenue is not generated by increased taxes, it simply reduces unintended tax sheltering in agriculture.

DESIRABLE CHANGES

S. 1786 is a very strong step toward "leveling the playing field" across sectors of the economy. It would end the current set of incentives that promote development of wetlands and highly erodible lands. It would be improved with a few changes that are contained in the House-passed Daub-Dorgan provisions written into H. R. 3838 and the Food Security Act of 1985.

More Inclusive Language: S. 1786 requires that all conversion of highly erodible lands and wetlands must be completed with a conservation plan approved by the Soil Conservation Service if taxpayers want to retain their credits and deductions. The Daub-Dorgan agricultural provisions written into H.R. 3838 are more inclusive. H.R. 3838 requires conservation plans for all lands that are converted if the credits and deductions are to be retained, not just the fragile lands addressed by S. 1786.

Audubon supports the more inclusive language in H.R. 3838. A large number of acres of land that is converted to farmland suffers from unacceptably high rates of erosion, but is not classified as "highly erodible land" under the land capability classification system. Conservation systems are able to substantially reduce excessive erosion. If no conservation plans are followed, however, valuable conservation practices would not be utilized.

Elimination of Section 182: Under section 182 of the Internal Revenue Code, developers are allowed to deduct the costs they incur from clearing land only for the "purpose of making such land suitable for use in farming."[21] Clearing land is defined as "[t]he eradication of trees, stumps, and brush, the treatment or moving of earth, and the diversion of streams and watercourses."[22] Developers are also able to accelerate the depreciation of their equipment that is used to complete the clearing. The total amount deductible is $5,000 or 25 percent of the taxable income derived from farming, whichever amount is lesser. With this expense treatment, farmers can deduct costs in the year they are incurred and then later receive the capital gains benefits when their improved land is sold at a higher price.

Land clearing deductions have been very costly to the government and wildlife. In 1982, government subsidies to farmers for clearing land were 65.6 million dollars.[23] Additional costs to the federal government include higher deficiency payments caused by the lower prices of surplus commodities and a greater number of acres covered by price supports. Forestland, rangeland, and pastureland, as well as wetlands provide unique natural habitats for many animals. However, government subsidies have increased the conversion of these land. As these areas are converted to agriculture the concentration of wild animals increases, leading to a more precarious existence and a greater possibility of declining populations. One example of wildlife displacement is found in Montana. In the Angela farm unit, a 97 percent reduction in the numbers of antelope was recorded after the plowing of a 20,000 acre block in 1977.[24]

If the costs of land clearing would no longer be deductible, the costs would be capitalized and depreciated, or if the improvements have infinite lives, then they would be deducted from capital gains upon the sale of the land. The effects of this would be twofold. Overall we would see a reduction in the number of new acres of farmland brought under production. Since high bracket speculators enjoy higher per-acre subsidies for land clearing, so distributionally we would expect to see relatively less cropland developed by speculators seeking after-tax profits and relatively more brought into production by the convervation-minded low and moderate income farmers.

Disaggregate Exceptions: Audubon recommends a technical change in the language of S. 1786. The provisions of the bill that deny credits, deductions and capital gains to operators who convert highly erodible land and wetlands do not apply when a farmer qualifies under one of the exceptions. The exceptions include: following an approved conservation system, land cultivated in the past five years, total farming unit is not predominately highly erodible or a wetland, or if the Soil Conservation Service determines that the land is not highly erodible or a wetland.

These exceptions vary from those allowed in the "Swampbusting and Sodbusting" sections of the Food Security Act of 1985. The Farm Bill recognizes the inherent differences in wetlands and highly erodible land by disaggregating the exceptions which apply to wetlands and those which apply to highly erodible lands. For example, the purpose of a conservation system approved by

SCS is to reduce erosion. Erosion, however, is not the problem on wetlands where S. 1786 requires these systems to be applied. Conservation systems also assume the land can be farmed by using effective conservation practices, yet damage to wetlands once converted to agriculture is irreversible. A "properly applied" conservation system on a wetland is not possible. Therefore, it makes sense to target this specific exception to highly erodible land, not wetland.

We favor the following exceptions for wetlands. If a farmer has cultivated wetlands in any of the past five years due to drought, then he should not be allowed to cultivate it in normal years without losing credits, deductions and capital gains. For example, if a farmer cultivated a dry pothole in the past five years without changing the contour, he should be unable to fill the pothole and receive tax benefits. In the case of highly erodible land, a farmer should be required to follow a conservation system approved by the Soil Conservation Service. He should also be able to cultivate the highly erodible land without penalty if it has been farmed in two of the past five years, up until 1990, by which time the conservation compliance provision of the Food Security Act of 1985 requires acceptable conservation systems to be initiated on all highly erodible lands regardless of cropping history.

We oppose these exceptions provided in S. 1786:

- "such cultivation is in reliance of the determination by the SCS that the land is not highly erodible land or wetland."
- "such highly erodible land or wetland is not the predominate class of land comprising the total farming unit of land associated with such highly erodible land or wetland."

We oppose the first exception on the grounds that if land is highly erodible or a wetland under the definitions adopted by this bill, the SCS should not be able to arbitrarily declare the land otherwise. The second exception constitutes a large loophole by using the word predominant. Wetlands could be converted because they do not make up a predominant class of land of the total farming unit under this exception. For example, if a 300 acre Prairie Pothole or estuarine system was in the middle of a 1000 acre farm, the wetlands could be converted because the total farming unit is not predominately wetland. We support report language submitted with the Food Security Act of 1985 which allows the conversion of an insignificant postion of a wetland if the Secretary of Agriculture determines the hydrological and biological effects are truly minimal.

CONCLUSION

The National Audubon Society supports S. 1786 because we believe the tax code should not reward activities which damage the environment. By repealing credits and deductions for conversion of highly erodible lands and wetlands as well as capital gains from their sale, S. 1786 will simultaneously slow development of fragile lands and be revenue-enhancing. In addition, the repeal of the land clearing deductions in S. 1786 will direct resources away from a sector of the economy that is producing surpluses and will benefit wildlife as well as farmers with low to moderate incomes. We commend S. 1786 for inclusion in the Tax Reform legislation developed by this committee.

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STATEMENT FOR THE RECORD

OF

WILLIAM R. JONES, JR.
PRESIDENT
NATIONAL CONSTRUCTORS ASSOCIATION

ON

COMPETITIVE IMPLICATIONS
OF
PROPOSED TAX REFORM LEGISLATION

COMMITTEE ON FINANCE
THE UNITED STATES SENATE

FEBRUARY 18, 1986

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Mr. Chairman and Members of the Committee:

Introduction

The National Constructors Association (NCA) is pleased to have the opportunity to offer testimony on the effect of certain tax reform proposals on the ability of its members to compete in international markets. We want to bring to the Committee's attention our concern about a number of provisions included in the House-passed tax reform measure, particularly those which change the tax treatment of income earned by Americans working abroad.

The National Constructors Association is made up of some of the nation's largest firms engaged in the design and construction of major commercial, industrial and process facilities worldwide. Because of the prominent role many of these firms have played in the international design-construction market, NCA has traditionally taken an interest in legislative and regulatory issues which affect its members' ability to do business overseas. NCA member companies, in fact, formed the nucleus of and founded the U.S. and Overseas Tax Fairness Committee which played a prominent role in making Congress aware some years ago of the need for more favorable tax treatment of the foreign-earned income of U.S. expatriates. NCA has also been active on issues relating to the development of a more competitive export financing mechanism through the Export-Import Bank and has followed with great interest the progress of other regulatory and legislative issues affecting the international marketplace.

House Proposals

The House-passed tax reform bill (H.R. 3838) changes the Sec. 911 exclusion in two ways. First, the legislation lowers the exclusion from the current $80,000 to $75,000. Second, the excluded income is designated a preference item subject to a 25% minimum tax above a base of $40,000 if married filing jointly or $30,000 if single.

The latter proposal, the imposition of a minimum tax is by far the more onerous of the two. It would dramatically increase the tax liability of the typical American overseas working in a low foreign tax country. The attached examples illustrate how much this provision would increase the cost of maintaining U.S. personnel overseas.

The employee in the first example is married with no children and has a base pay of $56,700. His net pay if he remained in the U.S. is calculated to be $46,485. He is offered an incentive to take an overseas assignment of 20% of his base pay or $11,340, making his guaranteed net for the overseas post $56,825. If the minimum tax goes into effect this individual's employer would have to gross up his salary $7,417 to offset his minimum tax obligation and leave him with the same overseas guarantee.

The other examples show how the employer would calculate the compensation and tax obligations of the same individual with 1) a higher overseas incentive factor, and 2) the individual residing in a high tax foreign country. We hope these will be useful to the Committee and will be pleased to answer any questions regarding the calculations.

All the examples highlight a single very important fact:

> Sec. 911 provisions provide no "windfall" earnings to overseas Americans but simply help U.S. companies keep U.S. personnel costs in line with foreign competition.

Increasing the tax on these individuals simply adds to the cost of maintaining them overseas. And that added cost directly affects the competitiveness of U.S. businesses overseas and their ability to retain an international presence.

Frankly, this organization is dismayed by the necessity to revisit this issue which we thought was successfully resolved with the passage of the 1981 Economic Recovery Tax Act. The members of this Committee should easily recall the extensive hearings, the studies, and the testimony which preceded enactment of current Sec. 911 tax provisions. Many of the members of this Committee were, in fact, instrumental in the development and passage of that legislation.

911 is a Trade Issue not a Tax Issue

The facts which prompted these provisions have not changed since 1981. Americans must be competitive to survive in the international marketplace. The U.S. taxation of foreign earned income acts, for all practical purposes, as a tariff imposed by our government on the export of U.S. goods and services. That tax policy simply helps the industrial nations with which we must compete to increase their share of the international market at our expense.

These are facts which have been unconditionally supported not just by NCA, by the architect-engineering construction industry and by the business community in general, but also by organizations such as Republicans Abroad, Democrats Abroad, The President's Export Council and the Republican National Committee.

These groups have recognized that tax policy which places Americans overseas at a competitive disadvantage with this nation's major trading partners can only "exacerbate the balance of trade problems and cause a loss of jobs for Americans here and in foreign countries." 1/ The statement of the Republican National Committee, entitled Taxation of Americans Residing Abroad, further acknowledges the importance of maintaining American workers in foreign countries.

> The ability of American companies to place their representatives on foreign soil has three major positive effects:
>
> 1. It increases the volume of United States' exports because Americans residing abroad tend to order United States goods and services for both personal and business use.
> 2. It facilities future business for United States companies by establishing commercial relationships built up through personal contacts.
> 3. It trains Americans in international business techniques. All these factors when taken together, means jobs for Americans both at home and abroad. 2/

The Department of Commerce has long acknowledged the Sec. 911 exclusion as an important factor in this industry's ability to compete in international markets. In a July, 1984 report entitled A Competitive Assessment of the U.S. International Construction Industry the International Trade Administration of the Department of Commerce makes the following comment:

> A special set of factors affecting the competitiveness of U.S. firms seeking international construction work involves U.S. Government regulations for which there are generally no counterparts for non-U.S. competitors. Such regulations operate as disincentives both in terms of project costs and in terms of the risks of inadvertent non-compliance.

> For example, U.S. design and construction firms face a disadvantage in many foreign markets due to double taxation on some income. Many countries impose a tax on services used in their country (such as design work performed in the United States for foreign projects). However, U.S. tax law considers such servics U.S.-sourced, not foreign-sourced, and taxes accordingly. The Unitd States only makes taxes deduction allowances for foreign-sourced income. Most other countries make allowances for this particular type of foreign taxation, placing U.S. firms at a significant disadvantage on many projects.
>
> Another disincentive is the U.S. taxation of foreign-earned income of U.S. citizens working abroad. Although these taxes were eased in 1981 by the establishment of a large exemption, the new rules required that employee benefits in kind (such as housing and provisions for dependents' educational needs) be counted as income, thereby greatly reducing the benefit of the exemption. Consequently, U.S. firms still have to pay higher wages and benefits for U.S. managerial and technical personnel than if foreign-earned income were fully tax-exempt, as is the practice of most other nations. U.S. tax policies thus remain a competitive problem affecting the ability of U.S. design and construction firms to pursue foreign work using U.S. personnel. 3/

Their report's overall assessment of the industry's competitive advantages and disadvantages comes to the following general conclusion:

> In the present competitive environment for international construction services, U.S. firms overall appear to enjoy a competitive advantage in terms of experience and a reputation for quality of services provided, based on recognized technological and management capabilities, but are at a competitive disadvantage for projects on which competition is based on price, primarily because of higher labor costs and higher financing costs. 4/

The report emphasizes the U.S. design and construction firms are at a substantial competitive disadvantage under existing law where competition for overseas projects is based primarily on price, and notes that the technological and management capabilities of these firms offer their sole competitive advantage in these markets. Those capabilities rely on people. The U.S. engineers and managers of these projects represent the competitive edge which keeps these firms in business overseas. Provisions which make it more and more costly to maintain these people overseas may well erode that one last competitive edge.

The need to keep Americans in overseas markets was also recognized more recently by the Subcommittee on International Economic Policy and Trade, the House Foreign Affairs Committee as endorsed in the attached letter of October 24, 1985 from Chairman Don Bonker and Ranking Minority Member Toby Roth to Ways and Means Chairman Dan Rostenkowski. As the letter indicates:

> American companies wishing to compete abroad simply must have their representatives work and live where the markets are. Given the substantial barriers to American businesses abroad, major exporters have found the Sec. 911 exclusion an asset in their export promotion efforts since 1981: to cut back this exclusion now would only place another hurdle in front of employees of American corporations working hard to get and maintain overseas business.

Trade is a highly social process and depends on our on-the-scene knowledge of the marketplace, our contacts and visibility and our credibility. In today's international economy -- a system our nation substantially created -- we can't maintain our place in the market by reducing our presence. On the contrary, we should be doing everything we can do to increase it -- and by a very considerable percentage.

Impact of Exports on the U.S. Economy

There are always those who question the value of U.S. exports to the domestic economy. Despite the recent attention given in the press and in Congress to the problems of our expanding trade deficit, more concern has often focused on how to slow imports than on how to expand exports.

The NCA is one of four constituent associations which make up the International Engineering and Construction Industries Council (IECIC), an organization which also focuses on issues affecting the industry's ability to participate competitively in the international marketplace.

Recognizing the need to document the importance of exports to the domestic economy IECIC sponsored a special study on The Contribution of Architectural, Engineering and Construction Exports to the U.S. Economy. Conducted by Price-Waterhouse and released in April, 1985, this study is the first comprehensive analysis of the economic impact of the AEC exports on the U.S. economy. It measures the secondary effects as the revenues earned off-shore flow back into the U.S. economy. It also quantifies the economic impact of this export-oriented industry in terms of U.S. revenues, U.S. employment and U.S. tax revenues generated.

The following figures from the study illustrate what the architectural engineering-construction industry's work overseas means to the domestic economy. In 1983:

- The U.S. AEC industry had export revenues of approximately $19.6 billion of which $4.8 billion represents direct U.S. revenues.
- An additional $6.1 billion of domestic revenues were generated as a result of AEC exports.
- For every $1 billion of direct revenues produced by AEC exports there is an additional $1.27 billion of indirect revenues from associated sales of goods and services, employment, etc.
- Total U.S. employment resulting from AEC exports was 261,000.
- Every $1 billion in total U.S. revenues generated by AEC exports results in approximately 24,000 jobs.
- Total U.S. wages resulting from AEC exports were $6.3 billion.
- Total federal, corporate and personal income taxes resulting from AEC exports were $1.13 billion.
- AEC exports supported $1.4 billion in contracts to U.S. sub-contractors and the purchase of $1.9 billion in U.S. materials. 5/

Several additional tables included as part of that survey are attached to this testimony. Each member of the Committee was sent a copy of the full study under separate cover, but we will be pleased to provide additional information on the study as needed.

Although this study only addresses the impact of AEC exports, it is clear that the loss of AEC contracts would have a corresponding effect on domestic employment and tax revenues.

While U.S. tax policy is only one of many factors which will effect the AEC's ability to do business overseas, the Commerce Department study lists labor costs and financing as two of the most important elements affecting this industry's competitive posture in international markets. We believe proposed changes in the Sec. 911 exclusion would significantly increase the cost of maintaining U.S. personnel overseas and along with that increased cost would either come lost jobs or lost profitability.

Revenue Estimates and Reality

In face of the evidence that U.S. tax policy affects the ability of its citizens to compete overseas, how then can an increase in the tax on overseas earned income be justified?

1. Fairness. The imposition of a minimum tax on the income of U.S. citizens working overseas does not, as intended, simply require every U.S. citizen to pay a "fair share" of taxes on their income. Rather it adds to the employer's cost of maintaining U.S. personnel overseas and in effect, imposes a tariff on the export of U.S. know-how -- the technical and managerial expertise of American citizens in international markets.

For the most part, American employees of U.S. engineering-construction firms are assigned to overseas projects with a contractual compensation arrangement. Depending on the location of the project and the perceived hardships associated with living there, the American company may offer the individual a 20 - 50% incentive to accept the assignment. That incentive is calculated so that the individual, after adjustments for cost of living, housing, etc., receives a net pay 20% higher than his net pay would have been in the United States. Although the way each firm structures its compensation package varies, the result is basically the same.

The added tax liability under a minimum tax proposal would simply increase the employer's cost of keeping the individual on the overseas assignment. The tax liability would essentially be borne by the employer not the employee.

2. Simplicity. Minimum tax calculations would contribute another layer of complexity to what are often difficult tax returns for overseas Americans and would further complicate overseas compensation programs for their employers.

3. Revenues. The imposition of a minimum tax on overseas-earned income would force the return to the U.S. of many of the taxpayers who would supposedly be paying the increased taxes. U.S. firms would simply not maintain the same numbers of U.S. personnel on their projects and absorb the increased cost of maintaining these individuals overseas. They would, wherever possible, cut the U.S. staffing for the project and replace them with citizens of other nations with comparable qualifications. Reductions in the numbers of Americans at work overseas means fewer Americans to pay taxes. Fewer American taxpayers overseas means a smaller tax base overseas.

Citizens of other nations who would replace Americans on these projects do not pay U.S. taxes.

Where an American worker must be maintained on an existing contract, the added cost to keep the employee overseas would not typically be reimbursable by the client. It could, therefore, have an impact on the profitability of that project, on the company's net profits, and therefore, on the revenues IRS would collect on those profits.

Finally, many U.S. citizens overseas residing in high foreign tax countries would simply begin using the foreign tax credit instead of the exclusion. Currently, many U.S. AEC firms recommend that overseas personnel use the Sec. 911 exclusion regardless of the tax rates of the country of their residence. Even if the foreign tax rate is high, the Sec. 911 exclusion allows them to maintain their tax liability at a comparable level to what it would be if they used a foreign tax credit. By electing to take the exclusion, however, they have the added flexibility to move from one foreign assignment to another without having to worry about needing to elect the exclusion one year and the foreign tax credit the next, depending on the local tax rate. If the Sec. 911 exclusion is changed as proposed these individuals would simply switch to the foreign tax credit and adjust their moves to other assignments on that basis.

Indirect Consequences

No Jobs. Displaced American managers, engineers and technicians would be returned to the domestic employment pool increasing whatever unemployment pressures may already exist in a sluggish domestic construction market. As previous studies have indicated, if Americans are not overseas generating new jobs, then they're back home absorbing existing jobs at a time when there may not be enough jobs in the domestic economy to go around.

Procurement. It is difficult to precisely quantify, but easy to speculate on the impact in terms of the procurement of U.S. goods and materials to support overseas projects if Americans no longer staff these contracts. Few people realize the quantity of manufactured goods and materials and U.S. equipment necessary to design and construct a major industrial process facility overseas. In testimony presented for NCA several years ago, one NCA member company was able to quantify the procurement associated with several of its major overseas projects.

One project valued at $335 million, for example, included potential U.S. goods and services imports totalling $220 million -- equating roughly to 6,600 jobs for Americans. $150 million of that was in the form of equipment and materials ranging from valves manufactured in Worchester, Massachusetts to pipe fittings from Kentucky, and transformers from California.

One can only speculate what the impact on project procurement will be for a major facility staffed entirely by British engineers, even when a U.S. firm is the employer. Needless to say, foreign engineers are more likely to specify goods and materials which they know best -- from their home countries, not the United States.

Summary

In summary, changes in the Sec. 911 exclusion would:

- completely alter staffing considerations for overseas projects, particularly those in low-tax countries;
- result in lower profits for projects in progress before the effective date of the bill;
- hamper a United States firm's ability to move its best personnel from project-to-project as needed;
- further erode the competitiveness of the U.S. engineering-construction industry in overseas markets;
- effectively place a tariff on the export of U.S. manpower and expertise in the international marketplace;

- contribute to a further degeneration of already grim balance of trade figures.

It will not:

- Increase long-term revenues to the U.S. Treasury;
- either simplify the tax code or more fairly distribute the tax burden.

We urge the members of the Senate Finance Committee to weigh the impact of proposed changes in the Sec. 911 exclusion before being lured by what we believe may be misleading revenue estimates. We will, of course, be pleased to discuss with the members or staff any questions they may have with respect to this issue.

Other International Tax Issues

In closing, I should mention that the Sec. 911 exclusion is by no means the only tax issue of concern to the NCA. We share concerns expressed by other organizations such as the Emergency Committee for American Trade on proposed changes in the foreign tax credit, specifically the use of foreign tax credit "baskets." This approach at best would further complicate our overseas operations and greatly erode our ability to compete against major competitors which face no such tax approach.

Once again, we would remind the Committee that AEC industry firms cannot choose their overseas locations based on the tax policy of the country in question. They must go where there is work, and work is harder and harder to find. Tax policies which make it difficult for them to compete where work is available are clearly counterproductive.

In that regard the industry has many tax disincentives under existing law which remain unresolved. For example, U.S. firms are often taxed twice on income derived from "technical assistance services" provided with respect to an overseas cntract. Those services (engineering, design, etc.) performed in the U.S. in support of an overseas project are often considered part of the total revenues for the project in question and taxed accordingly by the country in which the project is located. The U.S., on the other hand, considers this income to be U.S.-sourced. The American firm is therefore effectively barred from using the foreign tax credit to offset its double tax liability.

NCA has supported legislation which would either change the sourcing rules with respect to this income or allow the deduction of the taxes paid to the foreign country. Either approach could solve the problem and eliminate one more disincentive to the export of our industry's services overseas.

We commend this Committee for reviewing the trade implications of tax reform proposals and urge, once again, that a more thorough analysis be made of these proposed changes before they are adopted.

These proposed tax practices would wholly ignore the value to the U.S., in the international marketplace, of American dedication, drive, energy, resourcefulness, managerial expertise and technological know-how -- things we take for granted here at home and that are built into our culture and work ethic. But anyone with experience knows that they give us a substantial advantage in overseas markets -- an enormous appeal -- if we can afford to keep Americans in the international marketplace. And that, of course, goes to the issue.

Americans must have incentives to work overseas. They must at least be on the same tax footing as the citizens from the competing industrial nations. We submit that the costs of tax policy changes which would affect that competitive edge in the international market are too high to ignore.

We appreciate the opportunity to bring these matters to the attention of the Committee and welcome any questions which may result from this testimony.

NATIONAL FOREIGN TRADE COUNCIL, INC.
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February 10, 1986

The National Foreign Trade Council, Inc. is an association of more than 500 companies engaged in all phases of international trade and investment. The Council is concerned that certain proposed changes embodied in HR 3838 will adversely affect the international competitiveness of U.S. industries.

Adoption of the proposals described below would significantly increase tax costs for U.S. businesses and place them at a competitive disadvantage both in the United States market and abroad.

FOREIGN TAX CREDIT

The bill would severely further limit the foreign tax credit in a number of abstruse, technical ways:

- 3 additional separate foreign income baskets would be established for computing additional limitations of the credit. These added limitation baskets dilute, if not eliminate, the ability to average high and low foreign taxes paid on total foreign income, clearly evidencing the bill's bias against averaging which is the essence of the overall limitation. The separate baskets produce the same effect as the per-country method would produce. The effect in some cases is more akin to that produced by the even more restrictive per-item method. Thus, in many cases, at least a disguised per-country limitation would effectively be in use, notwithstanding that that discredited limitation had ostensibly been rejected.

- unfairly, when generally low foreign taxed passive income is not actually low taxed, it would be put in a basket with high taxed income and not in the passive income basket, evidence of an anti-averaging bias even when the high and low foreign taxes are paid on the same kind of income.

- a special limitation would limit credits for foreign taxes withheld on gross interest income of banks to the lower hypothetical U.S. taxes payable on net interest income. No benefit whatsoever would be available for foreign taxes in excess of the limit. Competitor foreign banks will gleefully accept this windfall, which most likely will carry with it a consequential windfall for products of and jobs in the home country of the foreign bank, at the expense of U.S. products and jobs. Also, this provision will discourage U.S. banks from heeding the U.S. Treasury's call to extend additional loans to generally high tax developing countries. Finally, this special limitation is at least incongruous in view of the fact that the U.S. has levied, and on certain kinds of interest still levies, withholding taxes of its own on gross interest.

Reducing foreign source income and subdividing it into as many separate baskets as practicable has the effect of indirectly reducing the foreign tax credit. Accordingly, the credit would be additionally severely restricted by the following changes:

- new complex and difficult and expensive to implement "look-through" rules would be employed to determine the source and kind (for separate income baskets purposes) of income received from foreign corporations, partnerships and other entities.

- Changes in long standing source rules on which operations have been planned would convert what now is foreign source gross sales income into U.S. income. To avoid this deleterious result would require siting sales activities and associated jobs abroad. Also, there is no persuasive reason why sales income produced by a fixed place of business located outside the U.S. should not always be foreign source, regardless of whether produced by sales to related or unrelated persons, or why income from sales of intangibles should not be, as it is in Treasury II, foreign source if the intangible is used abroad. Contradictorily, although one reason for this change is that sales income not taxed abroad should not be considered foreign income, there is no counterpart rule that expenses not deductible abroad should similarly not be considered foreign.

- Changes in historical 80/20 company rules would convert some foreign income actually earned abroad into U.S. income, impacting on capital availability due to increased risk of U.S. withholding on payments to foreign persons.

- Changes that would require expenses to be allocated on a consolidated instead of a separate company basis would, for example, require the cost of debt raised in the U.S. for the use of the business of the U.S. company to be allocated to the business of a foreign affiliate as well, thus increasing U.S. income at the expense of foreign income.

- Until the end of taxable years beginning on or before August 1, 1987, 50% of Research and Development (R&D) expenses would be allocated against U.S. income and 50% against U.S. and foreign income. Afterwards, in the absence of affirmative action, 100% would be allocated between U.S. and foreign income. Since 1981 all R&D has been allocated against U.S. income. Congress has recognized that to do otherwise would jeopardize prized U.S. jobs and national security. Our foreign competitors must view this in the same way, since none of them require their companies to allocate R&D against their foreign income. In fact, they provide incentives to keep R&D at home.

All of these direct and indirect technical changes would in one way or another result in less available foreign tax credit, increased U.S. tax on foreign source income and a lessened ability to compete against foreign companies whose cost structure is unaffected. Thus, even if these proposed foreign tax credit changes were conceptually sound, it would be unwise to make the changes because of their adverse impact on competitiveness. But they are not conceptually sound and only a source of needed revenue that will probably not materialize because of the trade impact. By these yardsticks, therefore, these changes should not be made.

DIVIDEND PAID DEDUCTION

HR 3838 would allow corporations a 10 percent deduction for dividends paid, phased in over a 10-year period. The deduction, however, would not apply for dividends paid from income which had not been taxed in the U.S., even though it had been taxed in the country in which it was earned at rates equal to or even higher than the U.S. rate. Thus

- the relative investment attractiveness of U.S. firms having foreign operations would be diminished,

- the cost of capital for such firms would consequently be increased, and

- the production costs would be consequently raised, thereby working against the competitive position of U.S. but not competing foreign companies

So that companies doing business abroad are not discriminated against, a full deduction should be allowed to them so long as the income source of the dividend has borne tax at a rate at least equal to the U.S. rate.

DEPRECIATION AND INVESTMENT TAX CREDIT

The bill would repeal the investment tax credit. The existing Accelerated Cost Recovery System (ACRS) would be replaced with a new "Incentive Depreciation System" (IDS) that extends the recovery period for most tangible property.

The effect of these proposals would be:

- to drastically increase the cost of capital, thereby reducing investment levels and jobs.

- to impact severely on exports; because while these provisions would have a very detrimental effect on all U.S. operations, they would have an even harsher effect on U.S. businesses selling abroad, especially to affiliate companies. To the extent that foreign taxes exceed the U.S. rate, lowering U.S. tax rates on foreign income of these companies below the foreign rate they pay will not compensate them for these cut-backs in capital recovery allowances.

Together, the current ACRS and ITC provide a capital recovery mechanism which places U.S. firms on a fairly equal footing with their foreign counterparts. Cutting back on the capital recovery rate of U.S. firms would confer an extra advantage on foreign competitors. Both immediate and longer-range adverse consequences of the proposal would include lower levels of productivity, competitiveness, jobs and U.S. security.

The current depreciation and ITC rules should be retained.

POSSESSION TAX CREDIT

For many years our tax laws have provided inducements for U.S. firms to institute operations in the possessions. In response, U.S. firms committed substantial capital and other resources to the possessions, especially Puerto Rico. Many of the products of these firms are subject to intense foreign competition. Over the last several years the tax benefits associated with possessions' income have been reduced. The full consequences of these changes have not yet been determined.

The President's tax reform proposals would have eliminated the possessions tax credit. While not as drastic as the provisions originally proposed by the President, HR 3838 would modify the rules governing the possessions companies. The case for the need for the modifications has not been made. The changes would increase the cost structure of U.S. possessions companies, following increased tax cost incurred by rule changes over the past several years. The result would be loss of market position.

The present possession company rules should not be changed.

TRANSFER OF INTANGIBLES

Under HR 3838, with the benefit of hindsight, royalties from related foreign corporations would be required to be commensurate with the income stream produced by the intangibles sold, contributed or licensed to the corporation, notwithstanding the validity of the terms of the conveyances at the time the intangibles were transferred. This new rule would be stricter than the third party comparability test of current law and could lead to deemed income from affiliates greater than that earned on similar licenses to third parties.

This imperious provision would create a mismatch between the income shown in the U.S. return of the transferor and the expense shown in the foreign return of the transferee, where the provision would undoubtedly need to be officially ignored, perhaps not only for foreign tax return purposes but also for U.S. dollar remittance purposes as well. The result would be an artificially high effective foreign tax rate, based upon U.S. earnings and profits calculations, with concomitant lost foreign tax credits. The increased tax cost to U.S. companies will, of course, redound to the competitive advantage of foreign counterparts not subject to similar extra-territorial rules.

This provision should not be enacted.

ACCELERATION OF U.S. TAX

The bill would strip U.S. banks, insurance and shipping companies of their right to defer reporting earnings of related foreign corporations until paid out as dividends. Up to now this right is enjoyed generally by these companies along with other U.S. shareholders, corporate or otherwise, of foreign corporations, so long as the income of the foreign corporation is earned in the active conduct of a trade or business. But, under HR 3838 banks, insurance and shipping companies would have to report the income as it is earned by the foreign corporation, even if the income is earned in the active conduct of a trade or business and is retained for reinvestment abroad and not paid out to shareholders.

This proposal discriminates against U.S. banks, insurance and shipping companies in favor of competing foreign corporations. In addition to helping them in other ways, the solicitous home countries of competing foreign corporations do not require them to so accelerate tax and in some cases do not tax the income at all. Obviously, the result is a higher cost structure for these U.S. companies, with concomitant competitive disadvantage to them.

Ironically, instead of inuring to the benefit of the U.S. Treasury, the accelerated tax might be skimmed off to the treasury of resentful foreign governments, who very well could react by instituting or accelerating tax on profits "deemed" remitted. In any event, tax collections will undoubtedly be much lower than projected as the income of disadvantaged U.S. companies withers.

An offensive factor about this provision is the widely held perception that this acceleration of tax is but another periodic slice taken out of the accepted concept that earnings of foreign corporations engaged in the active conduct of trade or business should not be taxable until repatriated, the slice again being taken at the expense of U.S. companies culled from the herd seemingly because they are considered 'currently politically vulnerable. In this fashion, over cycles, current targets of opportunity will eventually, in a piecemeal fashion, destroy the deferral concept in practice, even if it cannot be destroyed in concept.

This provision should not be enacted.

OTHER HR 3838 PROVISIONS ADVERSELY IMPACTING COMPETITIVENESS

1. FSC's - To foster exports, legislation was enacted just in 1984 to establish Foreign Sales Corporations (FSC). HR 3838 would chip away some of the FSC export tax incentives, unbelievably at the very time our trade deficit is huge and rising.

2. Tax Treaties - HR 3838 would override certain provisions of existing tax treaties. Tax treaties are the product of time-consuming deliberate negotiations based on trade offs of long term respective adverse positions. Under international law, these difficult to reach trade offs should not unilaterally be abrogated but should be changed with our treaty partners under orderly treaty processes. Apart from legalities, unilateral changes are bad business. Our treaty partners will consider our word to be unreliable, with adverse trade and investment consequences. At the very least, effective dates should provide ample time in which to renegotiate conflicts.

Aside from taxes and perhaps more importantly, if we violate our tax treaty obligations, the effect is certainly to place us in a lesser position to object to violations of all sorts of treaties by others.

3. Americans Working Abroad - To promote U.S. exports of manufactured goods and services, Section 911 provides an exclusion for a portion of the income earned by Americans working abroad. If anything, the need for this provision is greater today than ever. Yet, HR 3838 would not only reduce the exclusion by increasing amounts between 1986 and 1990 but also require its inclusion in the base for the minimum tax.

4. Simplicity - Objective simplicity is no longer a raison d'etre for tax reform, having lost its place to perceived revenue needs. However, for whatever reason, complexity, especially extreme complexity, carries with it a high cost to U.S. companies in time, effort and money.

Extreme complexity is particularly evident in the foreign tax credit provisions of HR 3838, under which U.S. companies would need to create, maintain and man numerous new sophisticated systems, procedures and records for every foreign corporation in which they are a 10% owner. It would be necessary to do so in order to be able to "look through" traditionally designated income (such as dividends and interest) received from, or through, several tiers of foreign corporations in an attempt to determine the "true" composition of that income and then: subdivide the income into its several baskets; match each basket's income with all its related expenses; and then finally determine if some passive income is high foreign taxed so that if so passive income can then be sub-subdivided.

The maintenance of such records would be costly, cumbersome and inefficient even in the case of controlled foreign subsidiaries; but it would be virtually impossible in the case of non-controlled foreign subsidiaries, creating an administrative nightmare for both taxpayers and the IRS. Many foreign countries restrict information which may be disseminated to non-residents. In addition, there are often legal controls over the level of financial information available to a non-controlling shareholder. (In this regard, it should be noted that the financial information available in the U.S. to a minority shareholder or other potential investor would not even begin to approximate the information which would be required to comply with the "look-through" provisions.) Due to the practical and legal barriers presented to a U.S. shareholder of a foreign corporation, the "look-through" provisions should be deleted or at least amended to apply only where there is control. Where the types of income otherwise subject to the "look-through" provisions are received from non-controlled entities, such income should be placed in the overall limitation basket.

Expanding the definition of controlled foreign corporation (from over 50% to 50% or more) does not change reality. In typical joint venture cases there is equal ownership between the U.S. and foreign persons. The U.S. shareholder cannot alone direct activities of the venture or its acquiescence to ever increasing compliance burdens imposed by the U.S.

This almost incomprehensible exercise would require the expenditure of not only costly but also scarce machine and people resources, causing a great incremental expense to U.S. companies but not to their foreign counterparts--another poignant example of how we seemingly take unnecessary and unwise steps to defeat ourselves in the world marketplaces.

5. Retroactivity - Aggravating the damage, all the changes proposed in the foreign area carry an effective date of January 1, 1986, so that they all would have retroactive effect. Fairness dictates that suitable transition rules be provided for pre-existing contracts, etc. Also, due to the difficulty that would be encountered in implementing these extremely complex provisions, especially those involving foreign corporations, a lead time of at least a year is required, to be able to properly comply.

CONCLUSION

It is contended, in defense of the foregoing proposals, that their negative impact is more than offset by the positive impact of tax rate reduction -- i.e., that on an aggregate basis U.S. tax on foreign income will decrease, not increase. That contention may be true in some cases, but not in the case of mainstream U.S. companies, as evidenced by their failure to embrace the proposals. To those companies, U.S. tax rate reduction on foreign income is either valueless or must be marked down substantially because their foreign tax rate is 46% or over or somewhere between 46% and the proposed reduced U.S. rate of 36%.

Accordingly, to mainstream operating companies, the proposals described above would significantly increase their tax cost, reduce their capital and thus impair their competitiveness in domestic and foreign markets. The adverse consequences would increase the trade deficit, reduce U.S. jobs and generate dangerous acrimony between us and our trading partners.

The proposals should not be enacted.

National Foreign Trade Council

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Supplementary Statement of the Emergency Committee for American ~~Free~~ Trade (ECAT) to be included as part of its February 4, 1986, statement to the Committee on Finance. N

STATEMENT OF GEORGE J. CLARK
EXECUTIVE VICE PRESIDENT
CITIBANK, N.A.
ON BEHALF OF THE NATIONAL FOREIGN TRADE COUNCIL
BEFORE THE
UNITED STATES SENATE COMMITTEE ON
BANKING, HOUSING AND URBAN AFFAIRS
HEARINGS ON
THE IMPACT OF H.R. 3838,
THE HOUSE-PASSED TAX REFORM BILL,
ON THE INTERNATIONAL COMPETITIVENESS OF
U.S. BANKS AND OTHER BUSINESSES

Tuesday, February 4, 1986

Mr. Chairman and Members of the Committee, I am George J. Clark, Executive Vice President of Citibank. I am pleased to appear today on behalf of the National Foreign Trade Council, an association of more than 500 companies engaged in all phases of international trade and investment, and to address the provisions of H.R. 3838 that primarily affect international business activities of U.S. companies. I am accompanied by John F. Rolph, III, Vice President, Citibank, and Chairman of the International Subcommittee of the Tax Committee of the NFTC. In particular, I would like to express opposition to the proposed foreign tax credit changes affecting international lending of U.S. banks, the elmination of the bad debt reserve for 2,500 banks and the changes in the deferral of foreign earned income. These provisions would hurt the U.S. economy, undermine our international trade position, and jeopardize the proposed solutions to the international debt crisis.

Of these three proposals, by far the most damaging in terms of its global impact is the disallowance of foreign tax credits on cross-border loan transactions. The House bill would very substantially reduce the foreign credits that U.S. banks may claim for gross withholding taxes paid on interest earned on cross-border loans made to foreign borrowers. This provision will force U.S. financial institutions, which provide more than one-third of international lending, either to cut back on their cross-border loans or not to make them at all. The supply of international credit will be slashed. In fact, this has already begun. A number of regional banks have recently advised government officials that they have now stopped making cross-border loans because of the foreign tax credit change in the House bill. Non-U.S. banks are unlikely to increase their international lending, and consequently, the cost of borrowing must rise. Less-developed countries, which are heavily dependent on loans from financial institutions, will suffer. Any reduction in the supply of such funds or an increase in price poses a real threat to their economies and, consequently, to the markets they provide for U.S. goods.

Developing countries purchased some $70 billion, or one-third, of U.S. merchandise exports in 1985. Cross-border loans are a key element in financing these sales. For example, two-thirds of Citibank's $900 million of private sector loans to Mexican borrowers have been made to finance purchases of U.S. goods by Mexican buyers.

Changes in the foreign tax credit provisions will impede the growth of U.S. exports. Regional and local banks finance the small- and medium-sized companies that today are developing new products and looking for new markets. Without the current tax credit, these banks will reduce and possibly abandon this business, and their customers will find it difficult to obtain financing elsewhere. Foreign banks are not a viable alternative for these companies and, in any event, foreign banks are not likely to promote the sale of U.S. goods. In addition, a slowdown in international lending by U.S. banks will put new upward pressure on the dollar. This will further reduce the demand for U.S. exports and worsen the $148.5 billion U.S. trade deficit.

What I have been discussing so far have been the probable effects of this foreign tax credit change. Let me discuss with you the immediate and certain results of this proposal.

The international banking community today is involved in the rescheduling of $400 billion of LDC debt. Because so many banks are reluctant, it is very difficult to put the rescheduling transactions together. H.R. 3838 will turn cross-border loans into losers or substandard earners. Banks which have been reluctant to support the effort to reschedule and restructure LDC credits will now have an easy excuse to withdraw. Given the magnitude of funds involved, $400 billion, and the need to keep all lenders in our rescheduling agreement, this exit opportunity could evolve into the global debt crisis that we have spent the last three years avoiding.

In addition to rescheduling our present outstanding debt, we are now starting to consider new lending under the Baker Initiative. Again, reluctant United States banks would like first to be repaid, but instead are going to be asked to put up new funds. The Initiative may be successful if the earnings on such loans are reasonable. H.R. 3838, as presently written, makes that impossible. The U.S. banks are going to say, "You are asking us to put up new money, which we don't want to do and then you tell us we can't earn on it. Forget it." Indeed, even Citibank, a strong supporter of the Initiative, could lose its enthusiasm because of the misdirected and negative provisions of H.R. 3838. Without the strong support of the U.S. banks, the Baker Initiative is going nowhere.

Although I have emphasized the drawbacks of this foreign tax credit proposal, I would be remiss if I did not draw your attention to the significance of the proposed repeal of the tax deductible bad debt reserve method for selected banks. This is by no means limited to the money-center banks, but affects nearly 2,500 U.S. banks. Like the foreign tax credit proposal, this provision of the House tax reform package raises the cost of credit. Currently, one of the factors considered in pricing a loan is the bad debt reserve deduction available for potential losses. If the reserve method is eliminated, the after-tax cost of providing for potential losses will be substantially increased. This in turn will require an increase in loan pricing, thus making credit more expensive. This effect is not limited to international lending. Domestic borrowers in the United States and local borrowers in the foreign markets served by U.S. banks will be affected as well. Increasing the cost of credit is not in anyone's best interest.

Furthermore, this provision will require the 2,500 banks to pay taxes over the next five years on the amount of their present bad debt reserves accumulated in acordance with the tax law since 1947. These extra taxes will directly reduce their financial earnings over the five-year period, without any additional financial income, causing potential cash flow problems for banks.

The net result is that the banks' retained earnings, a component of their capital, will be significantly reduced. Less capital translates into reduced lending ability. At a time when the Federal bank regulatory agencies are trying to strengthen bank capital, and the Administration has a major policy to increase lending to the LDCs, the tax laws should not undermine these efforts.

U.S. companies which operate overseas through foreign subsidiaries, will be faced with yet another tax constraint under H.R. 3838. The proposal to eliminate tax deferral for foreign subsidiaries which earn banking, insurance, shipping and certain other types of income discriminates against companies with these types of income. Thus, the U.S. parent company will be required to pay tax currently on these earnings of its foreign subsidiaries, even though these funds are not actually repatriated. This represents a pernicious change in long-established U.S. tax policy. The consequence is that foreign subsidiaries will not have the flexibility to retain earnings, free of U.S. tax, to expand operations abroad to market U.S. goods and services. U.S.-owned service companies are already at a disadvantage because their foreign competitors benefit from subsidies and protective tariffs. The proposed change in the deferral rules will put these firms at a further disadvantage.

We are also very concerned about the impact on trade and the availability of credit of other related foreign provisions in the House bill. Specifically, we refer to the separate baskets for calculating foreign tax credits, the changes in the source of income rules, the rules requiring allocation of interest and other expenses on a consolidated group basis and the modification of the possessions tax credit under Section 936 affecting Puerto Rico.

In our view, the provisions of the House bill that I have discussed are "penny wise and pound foolish". While some believe that these major tax law changes may increase Federal revenues, we believe they will create serious long-term consequences that will jeopardize America's future economic strength. They threaten the future of U.S. exports, which presently account for 4.5 million American jobs. Of more immediate importance, they jeopardize the $400 billion LDC debt restructuring effort and the Baker Initiative to stimulate the growth and development of LDC countries.

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STATEMENT OF
R. FAIN HAMBRIGHT, PRESIDENT
NATIONAL LEAGUE OF POSTMASTERS
BEFORE THE
SENATE FINANCE COMMITTEE
ON THE THREE-YEAR RECOVERY RULE FOR
CONTRIBUTORY PENSIONS
FEBRUARY, 1986

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE, I AM R. FAIN HAMBRIGHT, PRESIDENT OF THE NATIONAL LEAGUE OF POSTMASTERS. OUR ORGANIZATION REPRESENTS MORE THAN 23,000 POSTMASTERS THROUGHOUT AMERICA. WE ALSO REPRESENT MORE THAN 50,000 OTHER FEDERAL EMPLOYEES AS ASSOCIATE MEMBERS ENROLLED IN OUR POSTMASTERS BENEFIT PLAN. WE APPRECIATE THE OPPORTUNITY TO MAKE OUR VIEWS KNOWN TO THE SENATE FINANCE COMMITTEE ON A VERY IMPORTANT PROVISION OF THE TAX CODE, THE THREE-YEAR RECOVERY RULE FOR CONTRIBUTORY DEFINED BENEFIT PENSION PLANS.

THE NATIONAL LEAGUE OF POSTMASTERS WOULD LIKE TO STATE OUR UNEQUIVOCAL OPPOSITION TO ANY REPEAL OF THE CURRENT THREE-YEAR BASIS RECOVERY RULE FOR CONTRIBUTORY DEFINED BENEFIT PENSION PLANS. SUCH A REPEAL IS CONTAINED IN THE RECENTLY PASSED HOUSE "TAX REFORM" BILL, H.R. 3838, AS SECTION 1122(C).

WE OPPOSE REPEAL OF THE THREE-YEAR RECOVERY RULE FOR THREE REASONS. REPEAL UNDER THE HOUSE-PASSED BILL IS INEQUITABLE AND

SINGLES OUT POSTMASTERS, AND OTHER FEDERAL AND PUBLIC EMPLOYEES, FOR UNFAIR TREATMENT. REPEAL COULD RESULT IN A SUDDEN LOSS OF COUNTLESS EXPERIENCED POSTMASTERS WHO ARE ELIGIBLE TO RETIRE. AND REPEAL, IN OUR JUDGEMENT, WILL NOT RESULT IN THE "SAVINGS" ESTIMATED DUE TO THE INCREASE IN ANNUITY OUTLAYS AND THE COSTS OF REPLACING MANY SENIOR EMPLOYEES.

IN CONTRAST TO THE PRIVATE SECTOR, WHERE MOST EMPLOYEES CONTRIBUTE NOTHING TOWARD THEIR PENSIONS AND, INDEED, OFTEN HAVE ACCESS TO TAX-DEFERRED "THRIFT PLANS", GOVERNMENT RETIREMENT SYSTEMS RELY HEAVILY ON CONTRIBUTIONS FROM COVERED EMPLOYEES. FEDERAL EMPLOYEE CONTRIBUTIONS ARE FULLY TAXED AT THE TIME THEY ARE MADE. POSTMASTERS DO NOT OBJECT TO CONTRIBUTING TOWARD THEIR RETIREMENT; WE ARE WILLING TO PAY TAXES EQUALLY WITH ALL CITIZENS. HOWEVER, GIVEN EXISTING CONDITIONS, IT IS ONLY RIGHT AND PROPER THAT, WHEN THEY RETIRE, POSTMASTERS GET BACK WHAT THEY HAVE PUT INTO THE SYSTEM FOR SO MANY YEARS.

UNDER CURRENT LAW, POSTMASTERS, AND OTHER CIVIL SERVICE AND PUBLIC EMPLOYEES, HAVE A PERIOD OF UP TO THREE YEARS AFTER RETIREMENT TO RECOUP THEIR INDIVIDUAL PAYMENTS. DURING THIS TIME, THEY DO NOT PAY TAXES ON THEIR ANNUITIES, AS THIS MONEY WAS PREVIOUSLY TAXED. THE CURRENT SYSTEM IS FAIR AND SHOULD NOT BE CHANGED.

UNDER THE HOUSE-PASSED TAX BILL, THE CURRENT THREE-YEAR RECOVERY RULE FOR CONTRIBUTORY PENSIONS WOULD BE REPEALED. INSTEAD, THE AMOUNT CONTRIBUTED BY EMPLOYEES TO THEIR PENSIONS WOULD BE

PARCELLED OUT OVER THEIR SUPPOSED, ACTUARILY-DETERMINED, "LIFE TIME", THUS EFFECTIVELY WIPING OUT THE BRIEF "TAX FREE" PERIOD. THE NATIONAL LEAGUE OF POSTMASTERS IS APPALLED THAT SUCH A CHANGE WOULD EVEN BE CONSIDERED, MUCH LESS INSTITUTED.

MANY POSTMASTERS PLAN FOR THEIR RETIREMENT YEARS IN ADVANCE. THEY HAVE COUNTED ON THE THREE-YEAR RECOVERY RULE IN THEIR PLANNING. THEY HAVE BEEN SUPPORTIVE OF THE GOVERNMENT BY BUYING U.S. SAVINGS BONDS TO MATURE DURING THE FIRST THREE YEARS OF RETIREMENT. THEY HAVE ADDITIONAL INCOME WHICH MUST BE RECEIVED DURING THOSE YEARS - FROM IRA'S, ACCRUED LEAVE PAYMENTS AND OTHER PLANNED INVESTMENTS. THE EFFECT OF THIS CHANGE WILL BE TO TAX THIS INCOME AT A SUBSTANTIALLY HIGHER RATE THAN WOULD APPLY UNDER CURRENT POLICY. IN FACT, POSTMASTERS WOULD BE PENALIZED FOR SAVING AND PLANNING FOR THEIR RETIREMENT! IT IS TOTALLY UNFAIR TO CHANGE THE RULES ABRUPTLY FOR EMPLOYEES WHO MAY BE ON THE EVE OF RETIREMENT AFTER YEARS OF PLANNING.

THERE IS NO OTHER SEGMENT OF INDIVIDUAL TAXPAYERS WHO WILL BE SO ADVERSELY AFFECTED BY PROVISIONS OF THE HOUSE "TAX REFORM" BILL. UNDER CURRENT LAW, THE GOVERNMENT GETS A VERY GOOD DEAL. TAXES ARE LEVIED ON INCOME WHICH EMPLOYEES DO NOT EVEN BEGIN TO RECEIVE FOR DECADES. THE GOVERNMENT HAS FULL USE OF THOSE REVENUES THROUGHOUT THAT PERIOD AND THEY ARE IMMEDIATELY DEPOSITED IN THE GENERAL FUND. UNLIKE TAX DEFERRED RETIREMENT INCOME, WHICH THIS COMMITTEE WILL UNDOUBTEDLY EXAMINE, THE CURRENT SITUATION FOR POSTMASTERS AND OTHER FEDERAL AND PUBLIC EMPLOYEES IS IMMEDIATE

TAXATION ON DEFERRED INCOME. WHILE POSTMASTERS ACCEPT THIS IMMEDIATE TAXATION ON DEFERRED INCOME, WE FIRMLY OPPOSE ANY FURTHER DEFERRAL ON ALREADY-TAXED DOLLARS FAR BEYOND INITIAL RETIREMENT. IT SHOULD ALSO BE KEPT IN MIND THAT CIVIL SERVICE RETIREMENT ANNUITIES, UNLIKE SOCIAL SECURITY, ARE FULLY TAXED.

THIS ADDITIONAL BURDEN COULD WELL BE THE FINAL BLOW FOR THE GENERALLY CAREER-EMPLOYEE, SENIOR, EXPERIENCED POSTMASTERS, WHO EFFECTIVELY RUN THE BEST POSTAL SERVICE IN THE WORLD. SUCH A CHANGE IN THE TAXATION OF THEIR ANNUITIES, PARTICULARLY COMBINED WITH THE CONTINUED ATTACKS ON CIVIL SERVICE RETIREMENT, PAY, HEALTH BENEFITS, AND COLAS, WILL PRESENT A POWERFUL INCENTIVE FOR THOSE POSTMASTERS WHO ARE ELIGIBLE, TO RETIRE BEFORE THE EFFECTIVE DATE OF THE CHANGE. THE LEAGUE ESTIMATES THAT APPROXIMATELY 20% OF ACTIVE POSTMASTERS ARE ELIGIBLE TO RETIRE. WHEREAS, UNDER NORMAL CIRCUMSTANCES, PERHAPS ONLY ABOUT 15% OF THOSE ELIGIBLE ACTUALLY RETIRE IN ANY ONE YEAR, IF THE THREE-YEAR RECOVERY RULE IS ELIMINATED, IT IS OUR VIEW THAT AS MANY AS 50% OF THOSE ELIGIBLE WILL RETIRE. OTHER REPRESENTATIVES OF FEDERAL EMPLOYEES PREDICT FIGURES EVEN HIGHER THAN THESE. SUCH A PRECIPITOUS EXODUS OF THE MOST EXPERIENCED, QUALIFIED EMPLOYEES WILL CAUSE SERIOUS DISRUPTIONS IN VITAL GOVERNMENT SERVICES, INCLUDING POSTAL SERVICES. ADDITIONALLY, GREATER ERROR RATES AND INEFFICIENCIES DUE TO THE USE OF LESS EXPERIENCED WORKERS WOULD BE LIKELY.

WE BELIEVE THE PROJECTED "SAVINGS" THAT WILL RESULT FROM ELIMINATION OF THE THREE-YEAR RECOVERY RULE ARE NOT ONLY GREATLY EXAGGERATED, BUT WITHOUT FOUNDATION. THE INCREASED NUMBER OF POSTMASTERS AND OTHER RETIREES RECEIVING GOVERNMENT ANNUITIES WILL SUBSTANTIALLY INCREASE THE OUTLAY OF RETIREMENT PAYMENTS, NOT TO MENTION LUMP SUM ACCRUED LEAVE PAYMENTS. THE COSTS OF RECRUITING AND TRAINING EMPLOYEES TO REPLACE THOSE LEAVING WILL RISE. ALL TOLD, THIS CHANGE COULD CONCEIVABLY END UP ACTUALLY COSTING THE FEDERAL GOVERNMENT, RATHER THAN RESULTING IN SAVINGS.

THE NATIONAL LEAGUE OF POSTMASTERS URGES THIS COMMITTEE, AND THE ENTIRE U.S. SENATE, TO REJECT ELIMINATION OF THE THREE-YEAR BASIS RECOVERY RULE FOR CONTRIBUTORY DEFINED BENEFIT PENSIONS AS PROPOSED BY THE HOUSE. SUCH A CHANGE IS PATENTLY UNFAIR, COULD ACCELERATE THE FLIGHT OF EXPERIENCED POSTMASTERS AND OTHER FEDERAL AND PUBLIC EMPLOYEES, AND MAY WELL RESULT IN COSTING THE GOVERNMENT A GREAT DEAL IN TERMS OF INCREASED BUDGET OUTLAYS, INCREASED ERROR RATES AND INEFFICIENCIES AND HIGHER RECRUITMENT AND TRAINING COSTS.

THE LEAGUE APPRECIATES THE OPPORTUNITY TO EXPRESS OUR VIEWS ON THIS IMPORTANT ISSUE, AND WE ARE PREPARED TO ASSIST THIS COMMITTEE IN ITS VERY DIFFICULT AND ARDUOUS TASK OF PROVIDING ALL CITIZENS OF THIS NATION A FAIR AND EQUITABLE TAX STRUCTURE.

NATIONAL LEASED HOUSING ASSOCIATION
COALITION FOR LOW AND MODERATE INCOME HOUSING
COUNCIL FOR RURAL HOUSING AND DEVELOPMENT

LOW INCOME RENTAL HOUSING - A PROPOSAL

I. Introduction

For almost 50 years, the Congress has carried out in a variety of ways a national commitment to decent, safe and affordable housing for low income persons. Since 1969, this commitment has included the provision of incentives contained in the Internal Revenue Code designed to produce and operate privately-owned multifamily housing for low income persons. Over the past several years, direct federal subsidies to construct this housing have been substantially eliminated, thus making the Tax Code incentives the only remaining tools to continue this national goal. It is important to emphasize that these incentives have resulted from considered policy decisions made by the Congress over a seventeen year period as an essential element of public policy.

The undersigned organizations -- the National Leased Housing Association, the Coalition for Low and Moderate Income Housing, and the Council for Rural Housing and Development -- represent businesses, non-profits, and public agencies across the country with deep knowledge and experience in the development, financing and management of low income housing. They have worked closely with Congresses and Administrations over the past two decades in formulating and improving national policies to foster the production, management and preservation of low income housing.

There can be little doubt that tax incentives are necessary to spur private investment in low income housing. Investment will flow into a real estate transaction for three reasons: cash return, possibility of long term appreciation, and tax benefits. With low income housing, the first two reasons are essentially non-existent. Either as a matter of govenrmental regulation or because the income levels of the tenants do not permit rent levels adequate to support a development, there is generally little or no cash flow generated. Market appreciation may be restricted by government regulation which prohibits the use of the property for anything but low income housing for a decade or more, or market forces may lead to the same result. Thus, the only financial incentives are the benefits stemming from the Tax Code.

Furthermore, the need for low income housing continues, particularly in light of the elimination of federal production programs. Waiting lists for assisted housing opportunities and the growing numbers of families who are homeless because of their inability to find affordable housing are stark evidence of this national problem.

Certain aspects of the House-passed Tax Reform Act of 1985 did recognize the special needs of low income housing. However, other provisions, including the imposition of the Alternative Minimum Tax on "passive activity losses" more than offset these features. Overall, the House bill would seriously undermine the Nation's ability to provide needed low income housing.

II. Proposals

The undersigned organizations urge the Senate, in its consideration of tax reform legislation, to adopt the following provisions relating to low income housing. (For convenience, a brief summary of the corresponding provision in the House-passed bill is included).

1) Definition of Low Income Housing

In addition to the present definition of "low income housing" contained in Section 1250 of the Code, a new definition of that term should be adopted. In order to qualify, developments should meet one of two tests: either a) 25% of the project's dwelling units are rented to households whose incomes do not exceed 80% of area median income, or b) 20% of the units are rented to households not exceeding 70% of median.

In addition to the new definition, the present Section 1250 definitions should be retained. Generally, such definitions incorporate projects subsidized under extinct subsidy programs (e.g., Section 8, Section 236, etc.) However, to preserve the existing projects subsidized under these programs, the old definition should be retained so that such projects will continue to have favorable tax treatment on resale. Resale becomes essential at such time as an existing owner loses the financial incentive to operate the project.

(House bill - Defines "low income housing" in the same manner as proposed above. In addition, it defines "very low income housing" as projects in which 40% of the units are rented to households at/below 60% of median. This is an unrealistic definition as there is no available subsidy program that could allow for rents low enough that would be affordable by tenants at this level; accordingly, the House created a category into which no project can fit. Bill Sec. 201, proposed Section 168 (j)(3) of the Code. If the Senate decides that it is desirable to have a two-tier definition based upon targeting, it must make that targeting more realistic.)

2) Depreciation for Low Income Housing

Assuming the Senate adopts similar depreciation periods overall as are in the House bill, low income housing, as defined above, should receive a 20 year recovery period with the 200%

declining balance method. If the two-tier definition approach is to be utilized, the "very low income" tier should receive substantially more advantageous depreciation in order to compensate for whatever greater targeting is to be required.

(House bill -- Low income housing received 30 year/200% depreciation, which represents approximately a 50% reduction from present law treatment. This depreciation will make low income projects financially infeasible. Very low income housing, as defined in the bill, received 20 year/200% treatment. Section 201 of the bill, proposed Section 168(e)(2)(A) of the Code.)

3) Alternative Minimum Tax

As explained above, private investment in low income housing is generated by tax benefits. These benefits generally take the form of limited partnership losses which serve to shelter other income. If a "passive activity loss" provision like the one included in the House bill were to be enacted, then any other positive features related to low income housing in this legislation would be virtually eliminated. Therefore, if a "passive activity loss" measure is to be part of this bill, it should exempt low income housing. Furthermore, this provision should not be retroactive by including within its scope losses from existing partnerships as is provided in the House bill. In other words, if the policy decision is made to utilize tax incentives to encourage low income housing, then this policy should not be thwarted by putting losses from low income housing under the Alternative Minimum Tax.

In addition, if interest earned on multifamily housing bonds is treated as a preference item for AMT purposes, rents will have to be raised in developments financed by such bonds to compensate for the increased debt service costs which will be occasioned by subjecting these bonds to the 25% AMT rate. This factor may make many of these projects financially infeasible. Therefore, interest on multifamily bonds should not be treated as a preference item under the AMT.

(House bill -- "Excess passive activity losses", defined as the amount of net losses from such activities in excess of a taxpayer's cash basis in non "tax shelters" and the lesser of $50,000 or the taxpayer's cash basis in "tax shelters", are effectively treated as preference items for the AMT. Interest earned on "nonessential function bonds", which include multifamily housing bonds, is also treated as a preference item. Section 501 of the bill, proposed Sections 58(b) and 57(a)(6) of the Code.)

4) At-Risk Rule

Low income housing, as defined above, should continue, as under present law, to be exempted from the application of the at-risk rule. Exemption from "at risk" is essential if the utilization of tax incentives for low income housing is to be meaningful. (Also see discussion below under "Technical Concerns Arising Under H.R. 3838".)

(House bill -- All real estate, including low income housing, continued to be exempted from the at-risk rule, except for nonrecourse seller financing. Section 401 of the bill, proposed Section 465(b)(6) of the Code.)

5) Interest Deduction Limitations.

Low income housing should be exempted from any new limitations placed on the deductibility of interest. The exemption should apply regardless of the source of the financing on the development and regardless of whether the financing was generated by the issuance of tax-exempt bonds so long as the definitions set out above are satisfied.

(House bill -- Deductions of "nonbusiness" interest, which is defined to include interest expense allocable to a limited partner, would be limited to the sum of $20,000, plus interest payments on indebtedness secured by two homes, plus net investment income. Exemptions are provided for very low income housing and for low income housing but in the latter case only if the project is financed by tax-exempt bonds. Low income projects financed with conventional loans or under the Farmers Home Administration Section 515 program, which is a major source of financing in rural America, would not receive this exemption. This distinction has no rational basis. Exemption from the interest cap should rest on who is served by the program, not who finances it. Section 402 of the bill, proposed Section 163(d) of the Code.)

6) Capital Gains Treatment

Low income housing should continue, as under present law, to be accorded capital gains treatment upon sale or other disposition.

(House bill -- Depreciable property, including real estate, continued to be accorded capital gains treatment upon sale or other disposition. Section 241 of the bill, proposed Section 1202 of the Code.)

7) Construction Period Interest and Taxes

As under present law, interest and taxes incurred during construction of a low income development should be deductible currently. This major incentive for low income housing development is necessary to attract investors to such housing.

(House bill -- Present law, which permits current deductions for construction period interest and taxes, is repealed and replaced by a provision requiring capitalization of such expenses. Section 905 of the bill, proposed Section 263A of the Code.)

8) Section 167(k)

The present law which allows a five year amortization of rehabilitation expenditures for low income housing should be made permanent and the expenditure limitation of $20,000 per dwelling unit (which was established in 1976) should be increased, to reflect inflation, to $30,000 per unit.

(House bill -- Adopted the position outlined herein. Section 223 of the bill, proposed Section 167(k) of the Code.)

9) Tax-exempt Bonds for Multifamily Housing

Multifamily housing bonds should continue to be available to finance low income housing, but with the targeting definition for "low income housing" described in paragraph 1. Such bonds should not be subject to the unified state volume limitation. Otherwise, states will reallocate the cap away from the necessary but often politically unpopular item of low income housing to the more politically attractive industrial development bonds. Family size adjustments should not apply to projects occupied predominantly by the elderly, because applying such adjustments to elderly projects, which generally contain only efficiency or one-bedroom units, would make these projects financially infeasible.

(House bill -- Continues to authorize the issuance of multifamily housing bonds with the targeting definition of "low income housing", which is the same as being proposed here. Subjects such bonds to a unified state volume limitation; although $75 per capita in each state is set-aside for veterans', single family, and multifamily bonds, the set-aside can be overridden by the state. Family size adjustments are required with no exception for the elderly. Section 701 of the bill, proposed Section 142(c) of the Code.)

III. Technical Concerns Arising Under H.R. 3838

1) At-Risk Rule

The House bill provided that the revised at-risk rule, which would repeal the present law exemption for real estate insofar as it applies to seller financing, would be effective as to losses attributable to "property acquired" after December 31, 1985. (Section 401 of the bill.) The Ways and Means Committee Report (p. 295 of H. Rpt. 99-426) states that "property acquired" includes not only property acquired by a partnership but also interests in the partnership itself. The effect of this language will be to penalize partners who wish to sell their interests in partnerships which have acquired before 1986 existing property which was seller financed. The purchaser of such a partnership interest, under the Committee's language, would not be able to take into basis the seller financing portion of any debt, thus reducing substantially the value of and liquidity of the existing partner's interest. Thus, the Ways and

Means Committee has effectively made this provision retroactive with a very unfair result. The rules governing investments should not be drastically altered in this retroactive fashion to the great detriment of investors who made good faith decisions based on existing law. Controlling seller financing of property being acquired by an entity, which is the goal sought by the House bill, can still be accomplished by exerting that control at the ownership (e.g., partnership) level of that property and not by penalizing the partners' interests in the partnership itself as this Report language seeks to do.

If the Senate adopts the legislative language from the House bill on the at-risk rule, it is suggested that the Finance Committee Report explicitly state that:

> In the case of a partnership or S Corporation, property acquired means only property owned by the partnership or S corporation and not interests in the partnership or stock in the S corporation.

2) Recovery Period for Multifamily Housing Financed with Tax-Exempt Bonds

Under an anomaly contained in the House bill, in tax-exempt bond financed multifamily housing developments in which

a) the bonds are issued on or before December 31, 1985;

b) the development is placed in service on or after January 1, 1986 and does not qualify for transition rule relief (i.e., binding contract or construction commencement after September 25, 1985); and

c) the bond documents qualify for tax-exemption under Code provisions applicable in 1985,

the development would be required to use a recovery period of 40 years, rather than the 30 year period specified in H.R. 3838 or the 19 year period applicable under present law. This is the case even though the property is 20% low income and meets the other tests for qualified tax-exempt bond financing under present law -- the law in existence when the bonds were issued. The failure to meet the new rules governing multifamily housing bonds which are to be effective after 1985 causes the property to be considered bond financed non-low income housing. All such non-low income property must use 40 year straight-line depreciation under the House bill. (Sections 203 and 703 of the bill).

This unfair and unintended result should be rectified by adding to Section 203(c)(2) of the bill the following language.

(E) LOW INCOME HOUSING. - In the case of projects for residential rental property described in section 103(b)(4)(A) as in effect on December 31, 1985 financed with tax-exempt bonds, the provisions of subparagraph (C) of section 168 (b)(3) shall not apply.

* * * * *

The undersigned organizations would be pleased to work with Senators and their staffs toward the goals outlined in this paper. Please feel free to call upon Charles L. Edson (955-9779) or Richard S. Goldstein (955-9718), both of Lane and Edson, P.C. for further assistance.

National Leased Housing Association
The Coalition for Low and Moderate Income Housing
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Hon. Edward W. Brooke, *Honorary Chairperson*
Barry Zigas, *President*

PREPARED STATEMENT OF

BARRY ZIGAS, PRESIDENT

ON THE
IMPACTS OF H.R. 3838 ON LOW INCOME HOUSING

SUBMITTED TO

COMMITTEE ON FINANCE
U.S. SENATE

FEBRUARY 18, 1986

Mr. Chairman, I appreciate this opportunity to present a statement for the hearing record on behalf of the members of the National Low Income Housing Coalition. NLIHC is a national, nonprofit, nonpartisan organization representing individuals and organizations throughout the Nation. We provide advocacy services for these members to pursue policies at the federal level to end the low income housing crisis.

My testimony will address three broad areas:

1. the extent of the low income housing crisis and the federal government's current role in helping to end it;
2. the role which tax policy plays in federal housing policy, especially for low income people; and
3. specific comments on H.R. 3838.

The Low Income Housing Crisis

Mr. Chairman, low income people face a severe housing crisis. The shortage of affordable housing--either for rent or for homeownership--has driven thousands of families into the streets, into overcrowded housing, into desperation. The growing cancer of homelessness in cities throughout the country is a grim and potent reminder of how difficult it has become for so many thousands of people to put a roof over their heads.

Even for those who are fortunate enough to find shelter, the cost of a home can be frighteningly high. Analysis of the American Housing Survey by the Low Income Housing Information Service, an affiliated organization of NLIHC, shows that the vast majority of very low income households is paying exorbitant amounts for shelter. According to the 1983 AHS, over 8.4 million renter households earned less than $7,000 per year. These are the lowest income renters in the country, with incomes no greater than 50 percent of renter median, about 30 percent of national median, and less than 25 percent of owner median. Yet **among this group, about 90 percent paid more than 25 percent of their income for rent. About 80 percent paid more than 35 percent, and over half paid more than half their income for rent.**

President Reagan's Commission on Housing estimated in 1981 that over 7.5 million very low income renter households were eligible for federal rental housing assistance but unable to receive it because of program limitations.

Another recent analysis by LIHIS shows how desperate this situation has become for millions of low income renters. While there were over 8 million renter households with incomes below 50 percent of renter median in 1985, less than 4 million units of housing affordable to those renters at 30 percent or less of this income level were available in the market. Nearly twice as many very low income renters are seeking affordable rental housing

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than can be found in the market. A comparative analysis with similar figures from 1980 shows that the gulf between demand and supply of low income housing has widened substantially over the last five years. With your permission, Mr. Chairman, I would like to submit this analysis, called the **Rental Crisis Index**, as part of the record of this hearing.

The Federal Response

In the last five years, the federal government has beat an unprecedented retreat from its traditional policy of broad support for the needs of low income renters. Over 60 percent of the budget authority made available in 1981 has been slashed from subsequent budgets. New construction and substantial rehabilitation programs have been all but eliminated. The remaining assistance through Section 8 Certificates and the Administration's voucher demonstration has been slashed deeply, providing only a token level of assistance for low income renters.

These cuts have been made in the name of budget deficit reduction. Yet over the same period of time that Congress and the Administration were asking low income families to forego decent, affordable housing, the budget deficit more than tripled to its current levels.

This year, with the pressure of the Gramm-Rudman-Hollings budget legislation, the Administration will seek deferrals and rescissions of even the modest funds approved in FY86. The future promises little in additional assistance for low income renters. In fact, the Senate last year only narrowly rejected a proposal to eliminate funding for assisted housing altogether during debate on the HUD appropriation.

While the federal government has been busy sacrificing low income rental housing assistance on the altar of budget deficit reduction, it has been more generous to wealthy Americans. Out of a total expenditure last year of around $50 billion for housing assistance, low income people received about $10 billion through outlays in HUD's budget. Over $35 billion of the remainder was expended on wealthy homeowners through tax subsidies for mortgage interest, property taxes, and other special treatment. Not only were these subsidies left intact, but the President's budget for FY86 estimated a nearly 10 percent **increase** in such subsidies last year.

Only about $3 to $4 billion of this total was expended on investor incentives for multifamily rental housing development. Analyses published by the Joint Committee on Taxation suggest that investor deductions--those most directly addressed by H.R. 3838--will comprise only about 13 percent of all housing tax expenditures through FY90 under current law.

Mr. Chairman, the inequity of federal housing policy is manifest. Maintenance of costly and inefficient tax subsidies which primarily benefit wealthy people and encourage the over-consumption of secondary as well as principal residences at the expense of direct subsidies for the poor is a scandal. Congress' will to restore equity to the system through increased authorizations for direct low income housing assistance is weak.

Tax Reform in H.R. 3838

It is in this context of inequity, unfairness and abandonment of a compassionate and highly targeted national housing policy that I appear today to urge this Committee to help us protect and improve the tax-based subsidies which encourage low income housing development. I do so reluctantly. The National Low Income Housing Coalition has long deplored the use of such inefficient subsidies to accomplish national objectives. We have implored the Congress to increase direct spending so that such indirect and inefficient tax subsidies could be eliminated or curbed. But Congress has taken away most of the progressive and targeted assistance. It has forced us to seek the preservation of subsidies which increase the cost of subsidy to the taxpayer, and reduce the benefit to low income households.

This is the background to our suggestion to the Senate Finance Committee that it take this opportunity to restore genuine targeting of tax-based subsidies to provide housing opportunity for low income Americans. The provisions of H.R. 3838 are a major improvement on Treasury II. There are some provisions which should remain in any revised version of the bill. But there are also major problems with the approach taken by H.R. 3838 that this Committee has the opportunity and obligation to fix.

Our concerns with H.R. 3838 address the following issues:

1. The inadequate degree of targeting required to qualify projects for advantageous tax treatment.

2. The lack of any restrictions on the amount of rent which may be charged low income tenants in units qualifying as low income.

3. The lack of special tax treatment to foster the preservation of thousands of units of federally-insured existing low income rental projects occupied primarily by those with incomes below 80 percent of median.

4. The lack of any prohibitions against the use of tax exempt bonds to finance displacement of low and very low income tenants through acquisition and rehabilitation of existing, already occupied low income rental housing.

5. The unrealistic depreciation schedules applied to rental housing, particularly rental housing serving a high

proportion of low income tenants.

6. The imposition of unrealistic caps on IDB housing bond issuances.

7. The inclusion of income and losses from low income housing partnerships in calculation of the alternative minimum tax.

8. The exclusion of certain otherwise qualified low income properties from exemption from the business interest cap.

Constructive Proposals

I have attached a summary of our specific concerns with H.R. 3838 to this testimony. I request that it be included as part of my prepared statement. I would like here to outline some constructive proposals for change. These proposals were developed with the cooperation of an informal group of representatives from nonprofit development and advocacy organizations in Washington and elsewhere.

The principal focus of these recommendations is to restore to H.R. 3838 primary emphasis on providing tax subsidies to properties which principally serve low income households. The redefinition of "low income housing" in H.R. 3838 as projects in which only 25 percent of the tenants are low income is the most objectionable provision in the bill. It represents a complete retreat from years of historical treatment which gave projects in which 85 percent or more of the units were available to qualified tenants the most generous treatment in the Code. This preference for truly low income housing should and must be restored.

Replace the deduction provisions of H.R. 3838 with a tax credit

Using deductions to provide tax subsidies for qualified multifamily developments is inherently wasteful. Knowledgeable experts have estimated that 3 out of every 4 dollars in federal tax subsidy flows not to low income beneficiaries but to high income taxpayers or intermediaries through transaction costs. Converting this system to one of tax credits would greatly reduce the cost of these subsidies, increase their targeting to low income housing consumers, and simplify administration of the Code. The credits could be either refundable or non-refundable. If the former, they would provide nonprofit sponsors an especially effective source of development capital and greatly reduce the need to market projects to tax shelter oriented investors. If non-refundable, the credit approach could still greatly streamline the subsidy mechanism and increase the benefit of the tax subsidy to the consumer. We are continuing to work on this alternative to develop a complete proposal. I hope we can share this with the Committee as it is developed.

All of the proposals which follow assume the current deduction method of providing subsidies. However, the same overall structure could be supported by tax credits, and much more efficently. Although the following sections mention accelerated depreciation schedules, the same distinctions between and among the different classes of advantaged property could be provided through differentiated credits.

Restore Low Income Targeting Provisions to H.R. 3838

We propose establishing a new category of housing under the Code--Predominantly Low Income Housing (PLIH). This housing would be defined as that in which at least 80 percent of the units are occupied by tenants with 80 percent or less of median income. Rents in these projects must be limited to no more than 30 percent of 80 percent of median for qualifying households. PLIH projects would be eligible to receive 10 year, 200 percent depreciation. Current recapture provisions--no conversion to other use during the first ten years without complete recapture of tax subsidies taken, with a phase out over the next 10 years--would apply. In addition, if the property is sold or transferred after the first ten years, and the low income use is maintained, no penalty would apply. Properties which are otherwise eligible for Historic Tax Credits which qualify as PLIH would be able to enjoy the full appropriate credit. Again, use would have to be maintained for at least 10 years or stiff penalties would apply.

There are today thousands of units of previously subsidized and insured low income housing which H.R. 3838 will jeopardize. These properties are reaching the end of the recapture period for tax benefits under the current Code. Their owners are approaching a time when their primary concern will be to recover their investments from these properties after over 18 years. They are predominantly occupied by low income tenants, and represent an irreplaceable resource we cannot afford to lose.

H.R. 3838 will very likely accelerate the sale and conversion of these properties. At the very least, it will encourage their conversion from principally serving low income households to serving a market-based mix of tenants who can pay economic rents. Current low income tenants will not be eligible for any continuing federal assistance. They will not even qualify for relocation expenses if they are forced to move. The PLIH provisions should apply to any existing property which meets the 80/80 test, as well as to any housing insured under Sections 236 or 221(d)(3)(BMIR) of the National Housing Act, or under the direct loan programs

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of the Farmers Home Administration.

For properties in which rehabilitation was undertaken, Section 167(k) rules would apply as in H.R. 3838. However, if the property is sold within a reasonable time period to a qualified low income cooperative, it would qualify for a maximum $40,000 per unit rehab cost, rather than the $30,000 applied in H.R. 3838.

PLIH properties would be exempt from the at-risk rules, and H.R. 3838 would have to be amended in Section 401 to expand the at-risk exemption so that qualified nonrecourse financing would include such financing that "is used to acquire interests in property which is used and will be maintained as PLIH."

PLIH properties would be exempt from the limitation on nonbusiness interest deductions, and PLIH properties would qualify for special, favorable treatment under the alternative minimum tax.

Finally, we propose to include PLIH as an "essential governmental purpose" under the tax-exempt bond definitions. This would place such financing for qualified PLIH properties outside of the caps established for non-governmental bonds in H.R. 3838. We oppose the cap generally. But if Congress must impose one, we believe PLIH should be exempted. The vast majority of projects qualifying under PLIH will be existing properties. They cannot and will not compete effectively with new construction of multifamily or single family homes under a state-by-state cap. Moreover, we believe that the preservation of existing low income housing is an essential governmental function, and the Code should recognize this.

Provide for rent restrictions in targeted units

Neither current law nor H.R. 3838 mandates any limit on the rents which may be charged tenants in qualifying low income set-aside units. Thus, although assistance through tax subsidies is premised on the assumption that low income tenants will benefit from lower rents, there is no limitation on what those rents can actually be, except for what the market is willing to bear. An analysis of GAO's investigation last year of 7,500 IDB financed units shows that the average low income tenant in a set-aside unit is paying 29 percent of income. Tenants in non-qualifying units, on the other hand, were paying about 16 percent of income for rent. Clearly some qualifying tenants are paying more than 29 percent of income for these units--some may be paying a great deal more. Meanwhile, tenants in non-qualifying units are benefitting from a very substantial reduction in rent burden, compared with the 29 percent of median we estimate current median rents to be.

The principle of rent limitations in federally assisted low income properties is well-established in direct federal programs. I urge you to recommend that a similar limitation be imposed on projects which are receiving indirect, tax based subsidies, as well.

Anti-Displacement Guarantees

Neither H.R. 3838 nor the current Code contain any restrictions against the use of IDB financing to carry out acquisition and development which will lead to displacement of existing low or very low income tenants. Yet Legal Services attorneys and other local advocates report that a substantial portion of their displacement case load is the direct result of such IDB financed projects. The Senate tax bill should include a prohibition against using IDB financing in the acquisition, rehabilitation or new construction of any housing where low or very low income persons will be displaced by those of higher income. At the very least, we should insure that these tax subsidies are not used to aggravate the low income housing crisis.

Mixed Income Housing

H.R. 3838 provides some modest increase in targeting for the bulk of the projects which will be financed through tax subsidies--those undertaken by for-profit developers with the assistance of state or local housing finance agencies. It also creates a new class of properties in which 40 percent of the units would be occupied by tenants with 60 percent or less of area median.

These provisions may be necessary to create incentives for the development of rental housing in today's economy. However, they do not provide "low" or "very low" income housing. They **do** provide "Mixed Income Housing", and this is a function worth preserving in the Code for its own sake.

In lieu of this multi-layered approach, the National Low Income Housing Coalition proposes a single, more highly targeted program. This program would establish a single qualifying threshold--at least 20 percent of the units occupied by households at or below 80 percent of median, and an additional 10 percent at or below 50 percent of median. Reaching this threshold would assure the project of IDB eligibility and a 20-year, 200 percent depreciation schedule. Any project which exceeded these minimum thresholds would receive the same 5 year, 100 percent depreciation treatment that is available under Section 167(k) on a unit-by-unit basis for those projects which are occupied by tenants with incomes below 80 percent of median.

This single definition would restore a high degree of targeting to the Code's rental housing provisions. I assure you that this mix creates an economic product in most markets. In those where it does not, projects can seek additional subsidies, just as those which H.R. 3838 would create in the very low income category would have to. The difference is that this qualifying category would apply to the great majority of units likely to receive tax subsidies--those financed through IDBs by profit-motivated sponsors.

SUMMARY

Mr. Chairman, the tax Code is a blunt instrument for carrying out social policy. As I stated earlier, we would much prefer to see federal resources made available directly for low income housing development and preservation. But we have no reasonable expectation that Congress will reverse course this year or any time soon and increase its direct appropriations for low income housing assistance. In the meantime, the Nation faces an urgent housing crisis. Thousands of units of housing already subsidized by HUD face conversion to market rates in the next five years unless special tax treatment is extended to them. In general, the only production or preservation of affordable housing throughout the country is being undertaken by state and local agencies using tax-exempt bonds and other tax-based subsidies to attract equity investors. An entire nonprofit housing development sector has arisen since 1981 to try to fill the gap left by HUD in its retreat from development. The Finance Committee has the opportunity to take the steps necessary to make H.R. 3838 truly represent reform in the area of tax-based housing subsidies.I believe our proposals are a step in that direction, and I urge you and your colleagues to support them.

Thank you again for the opportunity to share our views with you on this important matter.

STATEMENT

BY

THOMAS K. ZAUCHA

PRESIDENT
AND
CHIEF EXECUTIVE OFFICER

ON BEHALF

OF

THE

NATIONAL GROCERS ASSOCIATION

TO THE

SENATE FINANCE COMMITTEE

FEBRUARY 21, 1986

Reform of the nation's tax system is a matter which vitally effects each of its personal and corporate citizens, and none more so than the members of the National Grocers Association. The N.G.A. is the national trade association representing the small business sector of the retail and wholesale food distribution industry. Its members include over 2,000 retail grocers and sixty-two wholesale distribution companies serving 28,000 food stores. Indeed, in the recent words of President Reagan, our membership "still epitomizes small business."

At the outset, it is important to note that in commencing its hearings on National Tax Policy, recent reports indicate that the Senate Finance Committee has elected to begin the process of tax reform "anew."

We congratulate the Committee for that decision. While some constructive efforts have already been made, there is no doubt that very considerable creative and innovative work remains to be done. To allow the previously passed House proposals to serve as a guiding focus of the debate simply because they were "already there" would be a major mistake.

While we strongly support desires for the emergence of constructive "new" approaches, we must caution this legislative body that thousands of businesses in every part of the nation have conducted, and are still conducting their day to day operations based upon the provisions of the present tax code. Effective future planning is simply not possible in an atmosphere of everchanging legislative uncertainty. Small businessmen and women simply cannot afford the lawyers and accountants necessary to sort through daily proposed changes in an already complicated code. Therefore, N.G.A. strongly recommends that Congress pass only prospective alterations. We endorse the efforts of certain Senators to set with the House a definate, future implementation date for any and all tax reform legislation. Such an implementation policy is necessary to promote expansive financing and capital spending by American businesses.

Having said this, it is important to turn to a comprehensive discussion of the actual content of current tax revision proposals and our suggestions for constructive alternatives.

I. Small Business

The historical role of small business in our society is without question. Successful small business was the original "American Dream." It has continued for more than 200 years to serve as the vital backbone of our entire American free enterprise system. Should anyone doubt the role which small business now plays, they need only review the last three annual "State of Small Business" Reports of President Reagan, or the more detailed "Annual Report on Small Business and Competition" submitted by the Small Business Administration. Their hundreds of pages point out that in our economic downturns it is small business which has been most resistant to economic decline, and in our present recovery it is small business which has distinctly been in the forefront. Whether measured by employment generation, expansion of sales, improvement in service innovation, or any other basis, small business has led the way.

Yet despite this prominence, any attempt to give meaning and definition to the term "small business" is a most difficult one. Depending upon the authority or report which is consulted "small business" may be measured by the size of the employed workforce, amount of assets, level of sales, totality of income, or other diverse categories. Who is right, who is wrong? It's hard to say.

And yet, "we know it when we see it." Each day we inevitably encounter small businessmen and women from the corner drug store to the local gas station to the neighborhood grocer or restaurant. All of them provide us with the services and products our life demands. In fact, in America today there is no simple definition of "small business." Rather, what all of us see and rely upon are hundreds and thousands of small "businesses", each one with its own diverse set of characteristics and priorities.

Indeed, the only real generality which one can make about the small business community is that no generality is possible. This aspect needs to be stressed. Far too often public discussion, and that surrounding tax revision, has tended to treat "small business" as a single, monolithic entity about which sweeping universal judgments could be made. What was good for 51% of small business would automatically be "good" for all 100%. In reality, a more sophisticated approach would reveal that the total community consists of a diversity of segments. That is our specific concern within this testimony to focus upon the proper role of government tax policy upon the increasing growth and investment oriented segment of small business. This group of firms is still of vital importance to the entire nation and its particular problems and requirements must be positively addressed.

II. Present Deficiencies

At the current moment the Senate Finance Committee and subsequently the Senate as a whole, is about to take up the issue of tax revision. Certainly the working basis for that discussion will be the collection of proposals embodied in the the House passed bill, H.R. 3838.

Yet we would contend that in the public and political excitement over "Tax Reform," there has been little serious examination of the micro and macro economic consequences of the bill. As Professor Paul C. Roberts, Chairman of the Institute for Political Economy, personally testified before the Finance Committee:

> "...neither the Administration nor the Congress has studied the impact that these changes would have on the cost of labor and capital in the United States; on the competitive position of U.S. goods and services in markets at home and abroad; or on individual trouble sectors of the economy such as agriculture. The best that the White House could do at a critical juncture in the debate was to produce two administration economists who declared that the bill would not cause a recession in 1986--hardly an endorsement. Indeed, the bill was supported by the President and passed by the House with everyone completely in the dark as to the bill's overall and specific economic impact."

Certainly this is the case when one begins to examine the legislation's potentially substantial impacts upon numerous small businesses. These impacts are of sufficient severity that they demand correction through constructive action by the Senate. In offering an analysis of various results to be expected from enactment of H.R. 3838 or similar legislation, we rely upon illustrations drawn from the progressive independent retail grocery industry. Numerous examples from other segments of the economy could be similarly advanced. The grocers have been selected because of the convenience of our own data base, and because of their representative nature. As President Ronald Reagan noted, "I cannot think of a better example of small businesses' contribution to our country's economic well being than that of the independent retail grocer." From such a representative background, our own analysis of the approach suggested in H.R. 3838 has concluded that: A. The interaction of corporate rate reduction and Investment Tax Credit elimination is unwise. A careful examination of the revised rate structures clearly shows that most businesses are unable to take significant advantage of the most substantial reductions in corporate rates, those at the very highest end of the scale. Yet they will suffer the loss of their one primary and most frequently utilized incentive to constructively compete and expand through modernization, format innovation and store expansion--the Investment Tax Credit.

Such a combination would most probably produce severe negative effects upon this nation's economic growth. For example, one recent study by Professors Meyer, Prakken, and Varvares estimates that by 1991 the House tax bill would result in a level of GNP 2.3% lower than under present law and an unemployment rate 1.1% higher. The Laurence H. Meyer and Associates econometric analysis concluded that between 1986 and 1991 the House tax bill would result in a level of GNP 2.3% lower than under present law, an unemployment rate 1.1.% higher and reduce real gross national product by a total of $145 billion.

Indeed, in a startling degree of unanimity, economist after economist has testified before this Committee that the final impact of the House bill would be distinctly anti-growth.

Such formidable "macro" numbers should not be allowed to obscure the "micro" effects which will fall as a particularly serious blow to growth oriented, expanding, constructive business persons.

To these enterprises, the "costs" of investing will now be dramatically, often prohibitively, increased. A representative of the U.S. Chamber of Commerce testified before the Senate Small Business Committee on February 6th that:

> "The repeal of the Investment Tax Credit (ITC) and the replacement of the Accelerated Cost Recovery System (ACRS) with the Incentive Depreciation System (IDS) would increase the after-tax cost of capital by as much as 19%, even when considering the reduction in the tax rate."

Such estimates have certainly been verified by numerous other authorities. Nor are these costs at all effectively compensated for by the reduction in rates, which are primarily in the upper brackets. No wonder that a recent comprehensive survey of the N.G.A. membership revealed that, "87% of the respondents said loss of the investment tax credit would slow or impede their business growth."

Of course, the ultimate losers in such cases will be the store owners themselves, a vital segment of the grocery community, and their customers who have trusted them to provide the high levels of service and convenience which their expertise and community interest permits. In such circumstances the entire country loses.

In short, economic investment, vital to this industry and to the nation as a whole, will be critically retarded or eliminated by total repeal of the ITC. As noted previously, while no claim can or should be made that this is true for every small business, it is especially true for the many who are most open to progress and expansion through investment improvements. Furthermore, B. The interaction of corporate rate reduction and Investment Tax Credit elimination is unfair.

One must begin here with the fundamental recognition that the ability to raise sufficient investment capital is often far more sharply restricted for smaller enterprises than it is for larger concerns. This is especially unfortunate when those same smaller businesses must compete with such a handicap against wealthier, larger corporations. But the simple facts are that small businesses simply do not have the equal, fair access to borrowed or new equity capital. This greatly increases the constructive role which the Investment Tax Credit has historically played in market equalization. And, of course, it serves to magnify the severity of its elimination. A comprehensive Staff Report prepared for the Senate Small Business Committee designed to summarize the findings of the thirteen field hearings which were conducted throughout 1985 concluded:

> "Retention of the investment tax credit in any tax reform package was one of the major issues focused on by witnesses in each of the thirteen field hearings. The ITC is part of the larger 'capital formation' issue for small business. Capital, whether it be through borrowed debt or equity investment, is frequently difficult for small business to obtain. Therefore, small firms must generally rely on earnings to generate the required capital for growth. The ITC is a mechanism which enhances cash flow by reducing tax liability, and has therefore become a particularly important source of capital to small businesses."

Unfortunately, these particularly urgent and immediate capital requirements of the small business community are totally ignored by the approach taken in H.R. 3838. Thorough examination of the data reveals that all businesses must surrender the Investment Tax Credit, but that the corresponding tradeoff--lower corporate income tax rates--benefit corporations in the highest bracket to a far greater degree. Thus the benefits of the rate interaction are not distributed progressively, but rather regressively. Moreover, one must understand that while the ITC may be a sometimes valuable accounting tool of larger businesses, it is often an essential feature of their smaller-moderate competitors providing vital financial assistance for progressive efforts to serve their customers. In short, by failing to allocate its burdens and benefits in an equitable, evenhanded manner, the Ways and Means bill fails fundamental tests of fairness.

No matter how frequently one may verbalize these conclusions they always seem more striking when confronted head on, in hard numerical form. As the following chart graphically demonstrates H.R. 3838 with its inequitable combination of rate reduction and elimination of the ITC greatly produces an unfair, unequal result which must be corrected.

Total Federal Income Tax

Taxable Income	Current Law	H.R. 3838 As Is	Percent Change
$ 50,000	$ 5,750	$ 7,500	+ 30.4%
100,000	20,750	22,750	+ 9.6
250,000	82,250	84,250	+ 2.4
500,000	184,000	180,000	- 2.6%
1,000,000	389,750	360,000	- 7.6%
10,000,000	4,100,000	3,600,000	- 12.2
100,000,000	41,000,000	36,000,000	- 12.2

(Chart assumes a progressive corporate investment pattern of 50% of taxable income resulting in an investment tax credit equal to 5% of taxable income. Minor expensing alterations are not considered.)

It should be noted here that for the vast majority of small businesses the level of rates and the existence and size of some constructive capital cost recovery system constitute the two principal determinants of economic growth and prosperity. Alterations in depreciation schedules are of far smaller significance. Indeed, under H.R. 3838 the proposed scaleback in depreciation would hit such enterprises with what Frank Swain, Chief Counsel for Advocacy of the U.S. Small Business Administration, labelled in his Senate testimony as a "double whammy." Certainly, its slower, less generous depreciation system is of concern, but as Mr. Swain explained, "Our research indicates that the ITC repeal will have at least 4 times the impact on small business as the depreciation changes in H.R. 3838." Nor are the accounting and expensing alterations contained in the bill of much significance. Given the complexity and limited reach of such provisions, virtually all experts see their impact as marginal at best. No, very clearly, the unfortunate rate reduction--ITC elimination tradeoff contained in the House proposal would set the future course for much of American free enterprise, and set it on a distinctly undesirable course.

In summary, progressive small businessmen and women in every walk of American life are seriously damaged by the principles embodied in H.R. 3838. Its reduction of general rates offers far greater benefit to those at the "top" of the scale than to those at the bottom or middle levels. Worse still, its total elimination of the Investment Tax Credit removes a crucial incentive to much needed expansion and growth.

III. Constructive Proposals

Any final disposition or revision of the scope and focus of the Investment Tax Credit should begin with a thorough understanding of its historical role within our tax system. At one of the field hearings conducted last year by the Senate Small Business Committee, Samuel R. Ludington, a C.P.A., reviewed that history noting that it was introduced in the early 1960s, twice since repealed ("suspended"), only to need to be reinstated (in 1967 and in 1971) to revive a stagnant economy, as well as two later increases in the ITC (in 1975 and 1981) for additional economic stimulation in particularly slow periods. He suggested that serious consideration be given to the history of these changes, and their positive effects on the economy, before abandoning the investment tax credit.

Such an historical record of repeatedly renewed legislative endorsement for sound economic rationales should not be ignored. Yet that is precisely the climate which seems to exist today. Too frequently, the present debate about investment incentives through the tax code has assumed an "all or nothing" quality. Either you are totally for the present ITC or you are totally against it. There is no room for any middle ground. This unrealistic atmosphere was well pointed out by Professor Murray Weidenbaum of the Washington University in St. Louis. He explained to this Committee that,

> "In the process, we see a political perpetual motion machine at work. That is, the institution of the investment tax credit and of liberalized depreciation were originally hailed as tax reform. Reversing policy on these investment incentives is now justified as tax reform."

In fact, shaping the debate in this fashion has seriously damaged the search for an intelligent compromise. Yet that is precisely what our goal should be. No one doubts that the ITC may contain some faults, but as former EPA Administrator, William Ruckelshaus, recently wrote in the New York Times:

> "It may be that we went too far in 1981. If so, why not fix what's broke? But to massively change our current tax code just to correct identifiable deficiencies unnecessarily risks the national interest."

Indeed, it seems obvious that given the nature of the experiences of so many small businessmen and women, and the ongoing critical role which some form of the Investment Tax Credit plays in their plans for progressive expansion and growth it would seem that the appropriate legislative task is one of modification and refinement, i.e. the protection and enhance of all beneficial features, with a corresponding reduction or elimination of those less desirable aspects.

After careful examination of the data and relevant expert interpretation and analysis, the N.G.A. feels that such a compromise, such a middle ground does exist. It exists in the shape of the concept of a Targeted, Limited Progressive ITC.

While the exact features of such an approach are subject to alteration, its main principles and direction are clear. (1) The imposition of a progressive structure of investment incentives. When translated into law, this would mean that as investments increased the taxation credits attached to them would decrease. (2) The substantial reduction or elimination of credit incentives at the upper end of the scale. (3) A determination of the various investment levels and taxation rate incentives based upon scales which would balance investment stimulus with equity and cost considerations. Such a proposal, if enacted, would continue to provide vitally needed economic support for the expansion and growth of small business with none of the waste, inefficiency and unfairness entailed in the present tax credit approach.

As we indicated previously, a variety of specific proposals are available. As models of the concept we have attached several specific appendices which set our possible implementation levels. Careful examination and review of their operations should reveal many of the initial potential benefits of this conceptual approach. (All data contained within these models was prepared by the accounting firm of Friedman and Fuller). See Appendix I, II, and III.

Obviously, the model proposals which we have included are not set in stone. They simply represent individual examples of a broader, more fundamental concept. As such a number of their specific features are subject to modification and refinement. (For example, the incremental rate differentials or the amount of purchases covered could be altered through different formulas. Similarly, each example extends the Investment Tax Credit to all investments, no matter how high, at a level of 1%. Cost or effectiveness considerations might lead to an elimination of this provision or to the imposition of a final "cap" at a lower ceiling level.) But the concept involved, that of a targeted, limited, cost-effective ITC remains clear. It rests upon four fundamental principles.

First, a targeted, limited ITC of the type described here would retain the empirically verified, beneficial investment incentives for growing small business found in the present tax code. As we have already noted, while large numbers of the nation's small businesses neither require nor utilize the ITC, for a definite constructive segment it constitutes a vital life support mechanism for further expansion and growth--expansion and growth which are also of major importance to our national economic health. While retaining these elements, the proposal offers absolutely no incentives for abuse of the provisions on the part of the small business community. (To the extent that most small businesses do not now heavily utilize the flat 10% credit they would assuredly not be attracted by the progressive rates found in these proposals.)

Second, targeted ITC's of the type described here, when combined with various rate reduction proposals, achieve a much more fair, much more equitable system than do the current rates of H.R. 3838. Such an emphasis upon fairness must be at the root of any and all consideration of massive tax code changes. Without it, the just principles of genuine tax reform are rapidly transformed into the unfortunate political compromises and influence of old fashioned tax revision. As the numbers which we have enclosed make very clear, our refinements and limitations of the ITC would interact with rate reductions to drastically narrow the range of benefit so that all businesses would be treated fairly and justly.

Third, enactment of an investment system which is heavily progressive in its rate structure (and even potentially capped) eliminates the most costly and most questionable utilization of the ITC under the tax code. Some leading economic authorities have expressed serious reservations about the value and effectiveness of tax investment incentives at the "upper end" of the scale. They argue that the benefits of such provisions for the heavy "smokestack" industries have been neither obvious nor significant and that virtually all examples of abuse and misuse of these provisions occur at these levels. All such problems are eliminated or overwhelmingly reduced under our proposals.

Finally, as we noted in the previous paragraph, an ITC which is heavily progressive in its rate structure virtually eliminates the most costly elements of the present investment tax credit. For example, utilizing the most recent available data from the IRS 1982 Corporation Source Book of Income we find that total corporate usage of the Investment Tax Credit in 1982 was $17.3 billion. But of the figure, $15 billion, or approximately 87% was earned by corporations with assets in excess of $25 million. (And it should be noted that the remaining amount of ITC credit was calculated upon a flat 10% basis; the progressive feature of the current proposals would reduce revenue loss even further.) Quite obviously, a targeted progressive ITC of the type described herein could be enacted with a minimum cost to the Treasury.

As SBA's Chief Counsel Swain concluded, "Some degree of focusing or capping the ITC would not only stem the revenue loss but provide the modest capital incentives that most small and start-up firms need." Indeed, the undoubted ability of this more sophisticated mechanism to actually work in promoting investment, employment, and growth would make such limited expenditures highly cost-beneficial and cost-effective.

Of course, actual transformation of the limited targeted Investment Tax Credit concept into legislative reality may well require further modification and alteration. Additional study, expert evaluation, and business reaction can only improve upon an already sound beginning.

But we at the National Grocers Association strongly believe that this concept represents an economic idea whose time has come. Numerous others enthusiastically share that judgment. Since our formal introduction of the targeted, progressive ITC a wide variety of individual businesspersons and associations have not merely endorsed its features, but pledged their active support for its passage. For example, the Small Business Legislative Council (SBLC) has formally "voted to approve the N.G.A. concept for inclusion in any new tax reform legislation." Of course we are conscious of the political pundits who have already pronounced the ITC as "politically dead." But with the constructive, dedicated engagement of important private and public figures, such as the members of this Committee, we believe that the final shape of tax revision legislation in 1986 will prove those reports to have been "greatly exaggerated" indeed.

In conclusion, the National Grocers Association wishes to reiterate its strong commitment to meaningful and constructive tax reformation. It should be noted that this is no open-ended or blanket commitment to any set of proposals, no matter what their content, which simply call themselves "tax reform." The "political perpetual motion machine" which Professor Wiendenbaum discussed earlier is a most powerful one; and the very real urge to "do something" is always difficult to resist. But national tax reform is far too important an issue for each and every one of our citizens to be determined by such instincts. As a concerned organization, the N.G.A. will vigorously oppose any final piece of legislation which falls short of our legitimate requirements. In doing so, it will join countless other informed, responsible individuals and groups who will work for the reality of tax reform, not simply its rhetoric.

APPENDIX I

Model One

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $1 million of investment purchases will receive an ITC of 10%.

(3) The second $1 million of investment purchases will receive an ITC of 8%.

(4) The third $1 million of investment purchases will receive an ITC of 6%.

(5) The fourth $1 million of investment purchases will receive an ITC of 4%

(6) The fifth $1 million of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 1,000,000 10%	2,000,000 8%	3,000,000 6%	4,000,000 4%	5,000,000 2%	1%	TOTAL ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	125,000	0	0	0	0	0	12,500
500,000	250,000	250,000	0	0	0	0	0	25,000
1,000,000	500,000	500,000	0	0	0	0	0	50,000
10,000,000	5,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	0	300,000
100,000,000	50,000,000	1,000,000	1,000,000	1,000,000	1,000,000	1,000,000	45,000,000	750,000

TAXABLE INCOME	CURRENT LAW TAX	ITC	NET TAX	PROPOSED LAW TAX	ITC	NET TAX	PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30%
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	16%
250,000	94,750	12,500	82,250	84,250	12,500	71,750	-13%	2%
500,000	209,750	25,000	184,750	180,000	25,000	155,000	-16%	-3%
1,000,000	439,750	50,000	389,750	360,000	50,000	310,000	-20%	-8%
10,000,000	4,600,000	500,000	4,100,000	3,600,000	300,000	3,300,000	-20%	-12%
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	750,000	35,250,000	-14%	-12%

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APPENDIX II

Model Two

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $500,000 of investment purchases will receive an ITC of 10%.

(3) The second $500,000 of investment purchases will receive an ITC of 8%.

(4) The third $500,000 of investment purchases will receive an ITC of 6%.

(5) The fourth $500,000 of investment purchases will receive an ITC of 4%

(6) The fifth $500,000 of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 500,000 10%	1,000,000 8%	1,500,000 6%	2,000,000 4%	2,500,000 2%	1%	TOTAL ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	125,000	0	0	0	0	0	12,500
500,000	250,000	250,000	0	0	0	0	0	25,000
1,000,000	500,000	500,000	0	0	0	0	0	50,000
10,000,000	5,000,000	500,000	500,000	500,000	500,000	500,000	2,500,000	175,000
100,000,000	50,000,000	500,000	500,000	500,000	500,000	500,000	47,500,000	625,000

TAXABLE INCOME	CURRENT LAW			PROPOSED LAW			PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
	TAX	ITC	NET TAX	TAX	ITC	NET TAX		
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30%
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	10%
250,000	94,750	12,500	82,250	84,250	12,500	71,750	-13%	2%
500,000	209,750	25,000	184,750	180,000	25,000	155,000	-16%	-3%
1,000,000	439,750	50,000	389,750	360,000	50,000	310,000	-20%	-8%
10,000,000	4,600,000	500,000	4,100,000	3,600,000	175,000	3,425,000	-16%	-12%
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	625,000	35,375,000	-14%	-12%

APPENDIX III

Model Three

Assumptions in this model include the following:

(1) Equipment purchases and other investments subject to the proposed ITC are set at a typical progressive rate of 50% of taxable income.

(2) The first $100,000 of investment purchases will receive an ITC of 10%.

(3) The second $100,000 of investment purchases will receive an ITC of 8%.

(4) The third $100,000 of investment purchases will receive an ITC of 6%.

(5) The fourth $100,000 of investment purchases will receive an ITC of 4%

(6) The fifth $100,000 of investment purchases will receive an ITC of 2%.

(7) All additional investment purchases will receive an ITC of 1%.

The accompanying statistical tables offer all relevant comparisons between the effects upon different levels of business of H.R. 3838 as currently constituted and H.R. 3838 as altered by inclusion of the modified ITC discussed above.

TAXABLE INCOME	PURCHASES 50%	BREAKDOWN OF PURCHASES 100,000 10%	200,000 8%	300,000 6%	400,000 4%	500,000 2%	1%	TOTAL ITC
50,000	25,000	25,000	0	0	0	0	0	2,500
100,000	50,000	50,000	0	0	0	0	0	5,000
250,000	125,000	100,000	25,000	0	0	0	0	12,000
500,000	250,000	100,000	100,000	50,000	0	0	0	21,000
1,000,000	500,000	100,000	100,000	100,000	100,000	100,000	0	30,000
10,000,000	5,000,000	100,000	100,000	100,000	100,000	100,000	4,500,000	75,000
100,000,000	50,000,000	100,000	100,000	100,000	100,000	100,000	49,500,000	525,000

TAXABLE INCOME	CURRENT LAW			PROPOSED LAW			PERCENTAGE DECREASE	PERCENTAGE CHANGE W/O ITC
	TAX	ITC	NET TAX	TAX	ITC	NET TAX		
50,000	8,250	2,500	5,750	7,500	2,500	5,000	-13%	30%
100,000	25,750	5,000	20,750	22,750	5,000	17,750	-14%	10%
250,000	94,750	12,500	82,250	84,250	12,000	72,250	-12%	2%
500,000	209,750	25,000	184,750	180,000	21,000	159,000	-14%	-3%
1,000,000	439,750	50,000	389,750	360,000	30,000	330,000	-15%	-8%
10,000,000	4,600,000	500,000	4,100,000	3,600,000	75,000	3,525,000	-14%	-12%
100,000,000	46,000,000	5,000,000	41,000,000	36,000,000	525,000	35,475,000	-13%	-12%

[2/05/86]

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N

National Military Family Association, Inc.

2666 Military Road, Arlington, Virginia 22207
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STATEMENT OF

MARGARET VINSON HALLGREN

DIRECTOR OF LEGISLATIVE AFFAIRS

NATIONAL MILITARY FAMILY ASSOCIATION

TO THE

SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

OF THE

SENATE FINANCE COMMITTEE

20 FEBRUARY 1986

Mr. Chairman:

The National Military Family Association (NMFA) is a volunteer, nonprofit association dedicated to improving the quality of life for the 10.1 million Americans in the military community. It is the only national organization whose primary focus is the military family. NMFA appreciates this opportunity to present its views to the members of the Senate Finance Committee on Internal Revenue Service Ruling 83-3.

IRS 83-3 disallows deductions for expenses which are allowable to tax-exempt income. This ruling is to become effective for military personnel after 1 January 1987, the date on which the current IRS moratorium is due to expire. It will eliminate the tax deduction for mortgage interest and real estate taxes paid on a military family's personal residence, except for payments over the amount of the tax-free government housing allowances.

NMFA endorses repeal of Revenue Ruling 83-3 as it would apply to the military by means of inclusion in Tax Reform legislation such as was contained in HR 3636 (Sec 144).

NMFA also supports S.1595, introduced by Sen. Warner, which would prevent application of Ruling 83-3 to housing allowances of the military (and the clergy). We urge the Finance Committee to report out S.1595.

The tax-exempt status of military allowances is not a fringe benefit but rather is an integral part of the total compensation package. The Uniformed Services Pay Act of 1965, and Sec. 101, Title 37, U.S. Code, reaffirmed inclusion of the Federal tax advantage of allowances as part of Regular Military Compensation. Congress has considered that advantage in setting military pay levels since 1965. The system of paying in allowances is a cost saving measure since retirement pay is calculated solely on basic pay.

Application of the Ruling to the military will result in a three to five percent pay cut for approximately 300,000 military homeowners whose tax liability will increase from $1000 to $5000 annually.

THE MILITARY HOMEOWNER AND THE HOUSING MARKET

The majority of military homeowners are career service members, and more than half are in the enlisted ranks. Eighty per cent of them are in the pay grade of O-3 or below.

Quarters are available for one quarter of the military population. The remainder must buy or rent a home.

The quality of family life is improved by the ownership of a home. In this highly mobile segment of the population, the instability resulting from frequent goverment-ordered moves may be ameliorated by home ownership and identification with a community. Air Force studies indicate a high preference for purchase of a home over rental. The income tax benefit is, of course, another principal reason for the preference.

- In many high density civilian communities surrounding military bases, the rental vancancy rates are extremely low (for example, 2% or less in California cities, 1% in Hawaii, 1% in Northern Virginia, and less than 1% in New York City).
- Because of the captive market in many areas, an rise in rental costs could be anticipated for the increased number of military who could not afford to buy if IRS 83-3 were in effect.

The opportunity for military personnel to save and build equity for the future is minimal both for the family that must rent in expensive areas as well as for the family that could afford to buy a home. Factors other than housing needs contribute to this situation, for example inadequate Permanent Change of Station (PCS) reimbursements and the 17% unemployment rate for military spouses.

It is difficult for a military family to qualify for a home loan and have the resources for a down payment and closing costs. If IRS 83-3 were to be implemented, realtors' figures indicate that a $100 per month loss of income would equate to approximately a $10,000 loss in purchasing power.

As of 1 March 1986, new requirements for a VA home loan will go into effect. These new requirements are:

- The amount of a loan that the VA will insure will be reduced from $133,250 to $90,000.
- The reinstatement privilege that has permitted military personnel to obtain another VA backed loan when the previously backed loan is paid off will be eliminated.
- Holders of VA loans will not be allowed to refinance.

OPTIONS AVAILABLE TO THE GOVERNMENT

1. Basic Pay Raise. This type of pay raise would go to all personnel, whereas only approximately 14% are homeowners.

- DoD estimates that a 1% pay raise to the force would cost more than $628 million. This figure more than doubles the estimated tax revenue generated by application of the Ruling to the present number of military homeowners. A 5% pay raise, to offset the estimated loss of income, would cost about $3 billion per year.
- Compensation through a basic pay raise actually would cost more than the figures given above, because retirement pay is calculated on basic pay only. Provision of housing (and other) allowanaces is a device that lessens the retired pay burden on the government.

2. Raise Basic Allownaces for Quarters (BAQ) and Variable Housing Allowance (VHA) Rates. By this method, over 800,000 people would

receive increased compensation, whereas only 300,000 are homeowners. The government pays over $4.6 billion in BAQ and VHA annually. A 10% increase in BAQ/VHA, raising the rates on average of $30 to $60 per month, would cost the government over $460 million per year. This cost is highter than the expected tax revenue from application of the ruling.

3. Raise BAQ and VHA for Homeowners. This method would result, monetarily, in a zero net gain to the government, since the raised BAQ and VHA to homeowners would offset their increased tax liability. However, the enforcement burden would be an adminstrative nightmare.

4. Build or Lease More Family Housing. The revenue gained from the application of the IRS ruling would be offset by meeting the housing demands of just 1.5% of the current homeowner population---by building (or leasing) only 4500 units. Realistically, at least 20% of current military homeowners would need government housing (approximately 60,000 families) with a resulting construction cost of an estimated $5.9 billion over the next few years.

EXEMPT MILITARY HOMEOWNERS

The options discussed above will cause the government either to provide compensation that would cost more than the revenue generated or to forego compensation and risk major problems in morale, retention, and recruiting. The costs of training replacements are soaring, especially in areas requiring advanced skills. There is a real possibility that a declining motivation of the careerist to recommend military life to others will have an impact on recruiting as well as retention.

NMFA urges that the Congress select the option of exempting military homeowners from application of IRS Ruling 83-3.

A recognition that family issues are critical to career decisions and to retention of a quality military force has been stated repeatedly by the Secretary of Defense, by the service chiefs, and by Members of Congress. The Congress has provided for many substantial improvements in the quality of life for military families. The military family cannot afford further erosion of benefits at a time when the civilian economy is increasingly stronger.

NMFA is concerned about the impact on military service members and their families that would result from implementation of the IRS ruling to the military.

How much longer can military families afford to continue in service to their country?

Thank you for the opportunity to present the position of the National Military Family Association on the effect of IRS Ruling 83-3 on military families.

N

National Retail Merchants Association

NRMA

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1000 Connecticut Avenue, N.W.
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February 21, 1986

The Honorable Bob Packwood
Chairman
Senate Finance Committee
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

On August 7 and October 9, 1985, the National Retail Merchants Association (NRMA)[1] submitted letters to the Committee which outlined our major concerns regarding the employee benefits provisions of the President's tax proposals to the Congress. Our letters stated that NRMA had gone on record strongly supporting the President's May 1985 tax proposals. However, with respect to the employee benefits provisions, we indicated that these provisions are not central elements of the tax proposals, would have a detrimental impact on many existing appropriately designed plans, and, therefore, recommended that these benefits provisions be separated from the other proprosals pending further analysis of their impact.

Now that the House of Representatives has approved the Tax Reform Act of 1985 (H.R. 3838) and sent it to the Senate for further action, this letter reiterates our prior position that the employee benefits provisions should not be part of the tax reform legislation but rather studied separately by the Treasury Department and the Congress. While NRMA continues to support tax reform, this letter emphasizes our strong recommendation that any changes involving the taxation of employee benefits should not be included in the tax reform legislation. However, if it is the intention of the Committee to proceed with consideration of the employee benefits provisions as an integral part of the Committee's tax reform bill and not as a separate issue, we wish to make further comments. While many of the provisions of the Tax Reform Act concerning benefits are appropriate, we have serious concerns with respect to two areas: certain retirement provisions and the welfare nondiscrimination rules.

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[1] NRMA is the nation's largest trade association for the general merchandise retailing industry. Our members operate 45,000 leading department, chain, independent and specialty stores in all 50 states. Annual sales exceed $150 billion and members employ more than 3 million workers.

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I. RETIREMENT PROVISIONS

A. 401(k) Savings Plan Provisions

H.R. 3838 containes provisions that would make several substantive changes in current 401(k) regulations. Some of these are reasonable; however, the proposed dollar maximum deferral and Average Deferral Percentage (ADP) special tests are inappropriate.

1. Maximum Deferrals

The proposed $7,000 overall limitation on contributions by an employee to a section 401(k) plan is unreasonably low. This amount is subject to further reduction to the extent that an employee-participant contributes to an IRA. This proposed limitation unfairly singles out section 401(k) plans for much harsher treatment than other qualified profit-sharing plans which would be subject to a proposed $25,000 overall limitation on employer contributions for an employee. A more appropriate maximum would be $15,000 without an IRA offset. One possible rationale for setting a maximum deferral amount would be to set the maximum deferral at one-third of the Social Security wage base which would be $14,000 in 1986 (one third of $42,000 under current law).

2. Average Deferral Percentage

The purpose of the current law Average Deferral Percentage tests applicable to 401(k) plans is to limit excessive tax-deferred contributions by highly compensated employees. H.R. 3838 would change both the definition of highly compensated employees and the contribution percentages under the ADP tests.

- The proposed definition of "highly compensated employee" would prevent middle income employees in many companies from saving meaningful amounts for their retirement. Depending upon the makeup of an employer's workforce, employees earning as little as $20,000 per year in some cases and $35,000 in others could be deemed highly compensated. In addition, the test as proposed is unnecessarily complex and would create administrative burdens. It would be more appropriate to define "highly compensated employee" as anyone earning in excess of $50,000 per annum, particularly for large corporations.

- The proposed changes in the savings (deferral) percentage allowed highly compensated employees in section 401(k) plans will cause employers to look to non-qualified plans to provide retirement benefits to management employees. Should this occur, employers may decide to severely restrict the retirement benefits available to non-management employees in qualified plans. The savings percentages allowed under existing law are reasonable in that they recognize that older employees who are close to retirement and earning more than their younger counterparts have a greater need and inclination to save for their retirement. The existing ADP test does an effective job of limiting higher paid employee deferrals. Therefore, the existing ADP should be retained.

3. Employer Matching Contributions

Under current law, employer matching contributions in a qualified savings plan must be nondiscriminatory. Employers are generally limited to matching employee savings up to 6 percent of an employee's compensation. H.R. 3838 would subject employer-matching contributions to a discrimination test similar to that imposed on tax deferred contributions. The bill would mandate one test for non-qualified employer matching contributions and a different test for other contributions. This complexity is further compounded by the bill's requirement that the tests for other contributions be applied separately for pre-tax employee deferrals, qualified company matches, and after-tax employee contributions. These tests would add unnecessary complexity and administrative difficulties without serving any additional purpose. Whatever test is determined appropriate, it should be used for all tax deferred contributions under a 401(k) plan. It is totally inappropriate to test post-tax contributions.

B. Favorable Tax Treatment on Lump Sum Distributions

Many employees have participated in retirement/profit sharing plans with the expectation of using the 10 year forward averaging and/or capital gains treatment, which H.R. 3838 would eliminate or phase out. H.R. 3838 substituted 5 year averaging for employees who are 59 1/2 or older and treated as ordinary income all other distributions. Because a lump sum distribution represents accumulations over the employees' working career, 10 year averaging is an appropriate method of taxing these accumulations. Therefore, there is no reason for the present 10 year averaging to be eliminated or reduced to 5 year averaging. If these proposed provisions are enacted, in the interests of fairness, employees should be permitted to use the favorable rules applicable to lump sum distributions for account balances in existence on the effective date of the new law.

C. Penalties on In-Service Withdrawal Distributions to Younger Employees

H.R. 3838 would impose a 15 percent tax penalty on so-called "premature" distributions from qualified retirement plans. This would include all distributions when the employee had attained age 59 1/2, became disabled, or died. The only exception would be for life annuity payments upon retirement. Penalty-free service withdrawals of all kinds, including those for bona fide hardship, would be eliminated.

The current distribution rules, which are more liberal for capital accumulation plans than for pension plans, should be retained. The proposed changes would discourage participation of younger employees in savings plans. It would also require employers to incur the burden and expense of maintaining qualified plan account balances for terminated employees. In addition, since deferred contribution plan funds would not become available before 59 1/2 except through the purchase of an annuity contract, the employer would need to add a life annuity option to any capital accumulation plan, and arrange with an insurer to purchase a commercial annuity. If these proposed provisions are enacted, hardship withdrawals should be retained, and penalty-free distributions of all types should be allowed for employees who retire under the terms of the plan.

Under H.R. 3838, the first funds withdrawn from an after-tax contribution account would be the interest earned and taxable. This is the reverse of the current law. This reordering of withdrawals would discourage participation by younger employees and reduce the amount available upon retirement. Therefore, the existing treatment should be retained.

D. Excess Distribution Penalty

Under H.R. 3838, a 15 percent penalty tax on excess distributions would be imposed on amounts in excess of $112,500 except for those employees receiving lump sum distributions eligible for special 5 year averaging in which case the amount is $562,500. Such a provision would restrict the employee's freedom to plan and manage his or her retirement income and should be eliminated.

2. WELFARE NONDISCRIMINATION RULES

The issue of nondiscrimination rules is not one of tax reform, but rather of regulations enforcing tax policy. New rules will not generally change the tax status of benefits, but will simply prescribe the rules to keep them nontaxable. Moreover, the development of effective nondiscrimination rules is a very complex undertaking. Given the diversity of employers, employee populations, and plan types, it is extremely difficult to develop rules that will be fair, reasonable and administratively appropriate for most employers and most plans. This endeavor should be handled separately from tax reform.

Apparently for these reasons, H.R. 3838 calls for the Treasury Department to study nondiscrimination rules for retirement/savings plans. The same approach should be used for welfare plan nondiscrimination rules. If the welfare nondiscrimination rules are to be included in tax reform legislation, then we recommend the revision of several provisions in the H.R. 3838.

A. Aggregation Rules

In applying the proposed nondiscrimination tests, all employees of a "controlled group" are treated as one group. The bill allows an exception to this "aggregation rule" for different lines of business and operating units. It is important that similar businesses that have different operating costs be considered separate business lines and be permitted to have different benefit programs. An example of similar businesses that are separate business lines would be specialty stores and discount store chains.

It is our understanding from a recent House Ways and Means Committee staff member's interpretation that the exception for operating units includes different geographic locations that function as separate units and contain a fair cross section of employees. This point should be clarified both in the bill's statutory language as well as in its accompanying report. This exception recognizes that different business lines compete in different price markets and thus have different constraints on labor costs. Requiring all business lines and operating units to have comparable benefit (labor) costs would make some lines uncompetitive in price. Therefore, it is very appropriate that this exception has been included.

However, requiring a minimum of 100 nonexcludable employees to qualify as a separate unit would present a hardship for a company comprised of several small locations (such as a chain of small stores). Such a company selling products or services in several geographic areas must establish prices that are competitive in each area. In addition, each location needs to provide benefits that are competitive and reflective of benefit costs for that area. Thus, it is frequently appropriate for such a firm to provide lower benefits and charge lower prices in a low cost (and low benefits) area, while providing higher benefits and charging higher prices in a higher cost area. This strategy is equally if not more important for a company comprised of small (under 100 employees) locations, as it is for one comprised of large locations. Therefore, the 100 employee minimum should be eliminated or significantly lowered.

B. Excludable Employees

H.R. 3838 permits certain employees to be excluded when applying the nondiscrimination eligibility test. NRMA considers the exclusions for employees under age 21, bargaining employees, and nonresident aliens who receive no U.S. source earned income to be appropriate. The exclusions for short service and part-time status are important to have. However, the proposed definitions of these two groups are inappropriate and other problems exist.

- Short Service Employees — The bill permits employees with less than 180 days of service to be excluded. Although 6 months is a reasonable time period for medical coverage, it is too short for dental and long term disability coverage that are sometimes provided after one year's service or longer (14 percent of companies provide dental coverage later than 6 months eligibility; 18 percent of companies provide long term disability coverage later than 6 months eligibility[2]). Therefore, a provision that permits the exclusion of employees with less than 1 year of service, consistent with current/proposed retirement/savings provisions should be used. A constant service requirement of one year, regardless of employee classification, would not affect the spirit of discrimination since all employees would be treated equally.

- Part-Time Employees — The proposed less than 20 hours weekly/1000 hour annually definition of part-time would provide a major hardship for many retailers because a 30-hour or less standard is frequently used as a definition of part-time status in our industry. This is important because most retailers employ a high percentage of part-time employees. Moreover, according to a recent survey,[3] less than half of employers currently provide medical benefits to employees working less than 30 hours per week. We recommend a 30 hour or less weekly or 1500 hours or less annually definition of part time.

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[2] Unless otherwise indicated, all data quoted in this letter is from the 1985 Hay/Huggins Benefits Comparison. The Comparison is a survey of benefit practices for salaried employees of 900 organizations representing a good cross section of medium and large size U.S. industrial, financial, and service employers.

- Special Exclusion Rule — In applying the nondiscrimination eligibility tests, the bill contains a provision eliminating the ability to exclude a group of employees (e.g. short service) from all welfare plans if that group were covered under any welfare plan. This approach is inconsistent with current U.S. practice where almost half of employers use more than one eligibility period for their various welfare plans. Typically, employers cover employees sooner in welfare plans that have the highest potential for greatest financial loss, such as medical plans and life insurance plans. As additional compensation and as a reward for continued service, employees are then included later in plans which have less potential for a substantial loss such as dental, vision and legal. The use of this special rule could very well result in the loss of coverage by some employees as employers standardize the eligibility requirements for all welfare plans at the most restrictive exclusion. Therefore, we recommend deletion of this rule.

- Eligibility Periods for Different Groups — The H.R. 3838 eligibility rules would oblige an employer to use the same eligibility period for all non-excluded employees. Many labor-intensive industries have a probationary period for employees with high turnover in the first few months (typically non-exempt employees) while there is no probationary period for other employee groups with minimum turnover during that period. It is appropriate to link benefit eligibility to the end of the probationary period. Therefore, eligibility periods that differ by employee group should be allowed.

C. Benefit Levels, Participation and Usage Requirements

The bill contains provisions requiring nondiscrimination in benefit levels, participation and usage. The provisions calling for uniform benefit levels are logical and fair and will ensure that plans are designed in a nondiscriminatory way. The bill calls for rules requiring certain percentages of plan participation by non-highly compensated employees for insurance-type coverage. Although these rules may be suitable for 100 percent employer-paid insured benefit plans, they are inappropriate for contributory plans. Employers simply cannot control who participates in a contributory plan. The retail industry (as well as several other industries) has a large percentage of "second income," seasonal, and part-time employees who have coverage elsewhere, or who consider coverage unimportant. Where these coverages are contributory, it is common for plan participation to be substantially less than 100%. The concept of contributory plans is important for many reasons, including cost containment. Any rule that penalizes a plan simply because it is contributory and therefore not utilized by all eligible employees is inappropriate.

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[3] Survey of Benefits for Part-Time Employees, Hewitt Associates. This is a national survey of 484 companies with non-union part-time employees.

In addition, the bill contains usage tests for non-insurance benefits (educational and child care assistance benefits). Such rules are inappropriate because employers cannot and should not control the usage of these plans or any other welfare plans. In addition, these tests would create a major administrative burden.

Under these proposed participation and usage rules many appropriately designed existing contributory insurance plans and educational and dependent care assistance plans would not pass the test. The inability of many plans to meet these tests would frequently result in the plan being terminated, thus leaving those employees who had coverage without it, and putting retailing and similar industries at a disadvantage. This would hurt the employees' educational opportunities, insurance protection and even their ability to work if they have dependents.

If almost all employees are eligible (as required by eligibility rules) and benefits provisions are designed in a non-discriminatory manner (as required by benefits level rules) then there is no need for participation percentage or usage tests. Therefore, the participation percentage and usage rules should be eliminated.

If they are not eliminated, the rules should be revised. Most appropriately designed plans would pass the proposed health care coverage rule. However, the coverage for other benefit plans are not appropriate. Most (81 percent) contributory life insurance plans do not have 75 percent participation, as would be required by the bill to be nondiscriminatory. It also seems likely that most educational and dependents care assistance programs would not pass the benefits received test proposed by the bill. The proposed test for health coverage would be appropriate for other welfare coverages and would also ease administration, and we therefore recommend its use instead of the different tests proposed.

3. **SUMMARY**

Employee benefit provisions are not central elements of the tax reform proposals, are very complex, and therefore, should be separated from the tax bill pending further analysis of their impact. If benefit provisions are included in the tax bill, certain changes should be made.

The proposed 401(k) maximum dollar deferral is unreasonably low and should be increased. The proposed definition of highly compensated employee would inappropriately include persons earning as little as $20,000 or $35,000. The earnings level definition should be simply defined as those earning in excess of $50,000 per annum. The existing ADP test is effective in limiting higher paid deferrals and should be continued. The proposed ADP test rules are very complex and burdensome and should be eliminated.

Proposed rules concerning favorable tax treatment for lump sum distributions and penalties on distributions are unfair and should be eliminated, or at least not apply to existing account balances.

The complex issue of nondiscrimination rules is not one of tax reform, but rather of regulations enforcing tax policy. Therefore, like retirement/savings plans, welfare nondiscrimination rules should not be part of the tax reform bill, but rather should be studied separately by the Treasury Department and the Congress. If necessary, appropriate rules could then be considered later.

If welfare nondiscrimination rules are included in the tax reform bill, then several of the provisions should be revised as they would have an adverse impact on appropriately designed welfare plans in the retail and other industries.

NRMA hopes that you will review these comments when you take action on H.R. 3838, the Tax Reform Act of 1985. We again thank you for the opportunity to provide our views on this important subject.

Sincerely,

Tracy Mullin

Tracy Mullin
Senior Vice President
Government Affairs

TM/MJA/pmm

cc: Members of the Senate Finance Committee

STATEMENT ON
TAX REFORM AND CAPITAL FORMATION

submitted by

National Society
of Public Accountants

FOR THE COMMITTEE ON
FINANCE
UNITED STATES SENATE
HEARING OF

February 6, 1986

Tax Reform and Capital Formation

The National Society of Public Accountants (NSPA) is pleased to submit this statement on the topic of Tax Reform and Capital Formation for the Senate Finance Committee hearing of February 6, 1986.

NSPA is a professional society representing ove- 17,000 practicing accountants located throughout the United States. The National Society also has an affiliated state organization in each of the 50 states, the District of Columbia and the Commonwealth of Puerto Rico.

The members of the National Society are, for the most part, sole or partners in moderately sized public accounting firms. NSPA members provide accounting, auditing, tax preparation, tax planning and management advisory services to more than 4 million individuals and small businesses. Members of NSPA are pledged to a strict code of professional ethics and rules of professional conduct.

The small business clients of our members have found it very difficult to implement a proper business plan given the major tax law changes that have occurred in the last several years. Since 1981, there have been three major tax bills enacted into law. Due to the Tax Reform Act of 1985

(H.R. 3838), as passed by the U.S. Representatives, the business community and individuals face an even more dramatic and substantive change in the tax laws. In specific, H.R. 3838 makes such monumental changes in the tax law that the Ways and Means Committee has deemed it necessary to rename the Tax Code as the Internal Revenue Code of 1985.

Public accountants appreciate the difficulty that frequent changes in the tax law can have on the ability of a small business person to implement a proper business plan. In this context, during the past few years we have testified before the Treasury Department and Congressional Committees and urged the establishment of a National Commission on Reform of the Income Tax System. The Commission would study and review the current Income Tax System to help Congress formulate a proposal for true tax reform. Further, we had asked for a moratorium on the enactment of any income tax law during a five-year period. This latter recommendation is a recognition of the negative impact that frequent changes in the tax law have on the business plans of entrepreneurs.

Tax Reform Act of 1985 (H.R. 3838)

Although we would prefer the establishment of a Commission on tax reform, we realize that H.R. 3878 has a reasonable chance of passage and thus, we would like to provide our comments on specific provisions of the legislation in order to help Congress formulate a more balanced package. In addition, we would like to make two specific recommendations on provisions that merit the Committee's consideration on tax reform, although such proposals are not included in H.R. 3838.

Cost Recovery Provisions

Section 201 of the H.R. 3838 provides for the repeal of the Accelerated Cost Recovery System (ACRS) and its replacement with the Incentive Depreciation System (IDS) for tangible property. NSPA supports the House Ways and Means Committee's approach regarding capital cost recovery.

When ACRS was enacted into law in 1981, it was based upon a recognition that the rate of productivity for U.S. manufacturing industry was dropping and as a result, the nation's business community was losing ground economically to our major trading partners. The so-called 10-5-3 depreciation proposal garnered tremendous support in Congress, the Reagan Administration, and in many sectors of industry as a way in which to encourage investment in new production facilities. However, ACRS was not supported broadly by the small business, high technology or service sectors of the economy. Ironically, these particular industrial sectors are the very segments of the economy which have created the predominance of the jobs for the American workforce.

By permitting taxpayers to depreciate personal property over 3-year, 5-year, 10-year or 15 year recovery periods (or 19 years for real property placed in service after May 8, 1985), the Tax Code permits taxpayers to depreciate equipment or buildings in a significantly shorter period of time than the true economic or useful life of the property.

Through the repeal of ACRS, the Ways and Means Committee is developing a more equitable system of business taxation. In the context of the Administration's proposal for lower marginal rates, NSPA believes that there is no need for a depreciation system which provides taxpayers an economic benefit far in excess of that which would be available under generally accepted accounting principles. Moreover, NSPA considers the repeal of ACRS, and its replacement with an Incentive Depreciation System (IDS) as an appropriate avenue through which to raise the necessary revenues to fund the reduction in marginal tax rates.

Investment Tax Credit

Whereas, ACRS might not be a necessary component of the capital formation process for small business, the investment tax credit (ITC) is. The ITC provides small firms with a meaningful increase in its cash flow in the year in which it makes a capital investment. Accordingly, NSPA favors the retention of the investment tax credit as a component of the capital formation process for the U.S. economy. Nevertheless, due to the importance of revenue neutrality, the National Society would support a $75,000 limit on the amount of investment tax credit that a taxpayer may take on its tax return for any one taxable year.

Corporate Tax Rates

H.R. 3838 provides for a reduction in the marginal tax rates for corporations as well as individuals. The legislation accomplishes this objective, in part, by reducing the top corporate rate from 46 percent to 36 percent. In specific, the Ways and Means Committee Report on the Tax Reform Act of 1985 (dated December 7, 1985), states in pertinent part as follows:

> "One of the most important objectives of the bill is to reduce marginal tax rates on income earned by individuals and businesses. Lower tax rates promote economic growth by increasing the rate of return on investment. Lower tax rates also improve the allocation of resources within the economy by reducing the impact of tax considerations on the choice between

> alternative investments. In addition, lower tax rates promote compliance by reducing the potential gain fron engaging in transactions designed to avoid or evade income tax."

NSPA is fully supportive of the proposal to reduce the top corporate rate to 36 percent, as well as the recognition by the Ways and Means Committee of the need to retain the graduated rates for small corporations. The Committee Report on H.R. 3838 states that "the present law graduated rates for lower income corporations are intended to encourage growth in small business by easing the tax burden on such businesses."

Although the Ways and Means Committee is generally supportive of graduated corporate tax rates, as provided for in H.R. 3838, NSPA is opposed to the proposal in the bill to phase out the graduated rates beginning at the level of $100,000 of taxable income.

As part of the need to increase federal revenues, the Deficit Reduction Act of 1984 (DEFRA) includes a provision which phases out the graduated rates for large corporatons. DEFRA phases out the benefits of the graduated rates for corporations with taxable income in excess of $1 million, by imposing an additional 5 percent tax (which is in addition to the regular 46 percent tax rate of current law) on the next $405,000 of taxable income.

Due to the current budget deficits and the need to attain a tax reform bill which is revenue neutral, NSPA recognizes that there may be a legitimate policy need for recapturing the benefit of the graduated rates at some threshold level. Nevertheless, the National Society believes that the threshold level for recapture should be significantly higher than the starting level (as under the bill) of $100,000.

Under the Tax Reform Act of 1985, due to the graduated rate schedule, a corporation would pay $22,750 in taxes on its first $100,000 of taxable income for an effective tax rate of 22.75 percent. The Ways and Means proposal would start recapturing the benefit of the graduated corporate rates by imposing the additional 5 percent surtax on corporations with $100,000 of taxable income or more. Until the point that the full benefit of the graduated corporate rates is recaptured, the effect of the recapture proposal is to impose a 41 percent marginal tax rate on each dollar of corporate taxable income in excess of $100,000.

Faced with a 41 percent marginal tax rate on taxable income between the levels of $100,000 and $365,000, corporations of that size level receive proportionately less of a tax benefit from the rate reductions than their larger corporation counterparts which are subject to a flat 36 percent corporate tax rate under the legislation, once the corporation has taxable income in excess of $365,000.

As a matter of tax equity, NSPA urges the Congress to consider raising the threshold for recapturing the benefit of the graduated rates to a level significantly higher than $100,000 of taxable income.

Alternative Minimum Tax

The Ways and Means Committee Report on H.R. 3838 states that the overriding objective for a minimum tax is "to ensure that no taxpayer with substantial economic income can avoid significant tax liability by using exclusions, deductions, and credits." "The ability of high-income taxpayers to pay little or no tax undermines respect for the entire tax system and, thus, for the incentive provisions themselves."

NSPA appreciates the Congressional Tax Writing Committee's concerns in this area. Nevertheless, the National Society believes that by setting the alternative minimum tax at a rate higher than the maximum effective tax rate for net long term capital gains for individuals (as H.R. 3838 does) this creates an inadvertent trap for the unwary. It is possible in an alternative minimum tax situation, under H.R. 3838, for LTCGs to be taxed at 25% rather than 22% as the Congress apparently wanted. Thus, we would suggest that the alternative minimum tax rate be no greater than the maximum effective tax rate for long-term capital gains.

Limitations on Deductions for Meals, Travel and Entertainment

Section 142 of H.R. 3838 provides for certain limitations on deductions for meals, travel and entertainment. In specific, this section provides that no deduction shall be allowed for the expense of any food or beverage unless:

"(1) the furnishing of such food or beverages has a clear business purpose presently related to the active conduct of a trade or business,

"(2) such expense is not lavish or extravagant under the circumstances, and

"(3) the taxpayer (or an employee of the taxpayer) is present at the furnishing of such food or beverages."

The bill places a further restriction on such expenses by limiting the allowable deduction on business meals and entertainment to 80 percent of the amount of the expense. NSPA is deeply concerned over this provision. The House of Representatives passed this provision because it felt that there was an abuse from "excess personal consumption."

By limiting business meal and entertainment deductions to 80 percent of the amount of the expense, NSPA believes that the proposed limitation will do little to restrict the personal consumption element of meal and entertainment expenditures. The National Society considers the limitation to be arbitrarily conceived and extremely subjective in design. Section 142 of H.R. 3838 will result in a compliance nightmare for taxpayers, resulting in an increase in IRS audits.

At-Risk Rules

The current tax law permits individuals and certain corporations to deduct losses from real estate which are in excess of the amount that they have "at risk." Except for certain transactions involving unrelated third-party nonrecourse debt, H.R. 3838 extends the scope of the "at-risk rules" to real estate. NSPA is opposed to this new limitation. Many small businesses are required to give or take seller financing. Thus, the limitation could result in a severe downturn in what may otherwise be productive investment by small business, such as investment in plant and equipment.

Cash or Deferred Arrangements (CODAs)

Given the increasing proportion of senior citizens and retired individuals in the U.S. population, there is an ever increasing need for a viable national retirement income policy. This national policy should strive for a secure private pension system designed to supplement the Social Security system.

NSPA believes that the pension provisions of H.R. 3838 move away from these objectives. The National Society is particularly concerned about the linkage of the IRA contributions with the $7,000 limitation on the amount that employees can defer yearly under qualified cash or deferred arrangements (the so-called 401(k) plans). More specifically, NSPA believes that there should be no linkage between the two retirement programs.

Qualified cash or deferrred arrangements have become increasingly attractive to rank and file employees of companies which offer such plans. Under the special nondiscrimination tests of current law, a company cannot offer a 401(k) plan to its employees where the plan disproportionately benefits highly compensated employees at the expense of rank and file workers. NSPA believes that the nondiscrimination requirements of current law have worked well in accomplishing the objective of assuring relative equity of financial benefits for employees of all income levels.

To the extent Congress and the Administration consider it

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necessary for budgetary reasons to place further restrictions on 401(k) plans, then the placement of a $7,000 limitation on the amount that employees can contribute yearly to a 401(k) plan may have merit for policy reasons. NSPA understands and would accept such a policy position. However, by linking the contribution limit for IRAs to the proposed $7,000 limit on 401(k) plans, H.R. 3838 adds a layer of complexity to two fundamentally independent national retirement programs.

The major appeal of individual retirement accounts to taxpayers has been the freedom of investment opportunity, as well as the simplicity of the retirement plan itself. By linking IRA contributions with 401(k) plans, taxpayers will be hindered by severe tax compliance problems. In addition to raising major recordkeeping problems for taxpayers and their employers, the linkage causes compliance problems for banks, securities firms, insurance companies and other financial institutions as well. NSPA is concerned that the cost of the recordkeeping burden will ultimately fall on the individual taxpayer.

The Practice Before the Tax Court of Enrolled Agents and CPAs

NSPA is fully supportive of section 1546 of the Tax Reform Act of 1985. As approved by the U.S. House of Representatives, this provision would permit enrolled agents and CPAs to represent taxpayers before the Small Tax Case Division of the Tax Court, with respect to disputes with the IRS of $10,000 or less. Trials of such cases are normally conducted informally and generally do not require the filing of briefs.

To the extent a taxpayer obtains outside assistance to prepare his income tax returns, he will very often utilize a CPA or enrolled agent. Thus, it is the CPA or enrolled agent which will likely be the most knowledgable about the particulars of the taxpayer's return. In a small dispute (such as ones involving amounts under $10,000) with the IRS, it would be very costly for the taxpayer to hire an attorney, who must then be paid to learn the case from scratch.

By permitting taxpayers to be represented in Tax Court by the professionals who filled out their return originally, this would greatly expedite the docket of small cases before the Tax Court. Thus, taxpayers would obtain effective professional representation before the Tax Court at a reasonable cost. In specific, this proposal would greatly simplify and expedite the resolution of taxpayer claims.

The Deposit Rules for Payroll Taxes

One of the major problems facing small business today involves payroll tax compliance. Since small businesses are often more labor intensive than their larger business counterparts, payroll taxes can impose a higher burden of compliance on smaller firms than other section of the tax law. The current law and regulations generally require a business to make payroll tax deposits with the IRS as often as it pays its employees, which may in many cases be four times a month. In the context of tax reform, NSPA urges that Congress give serious consideration to implementing procedures which lessen the payroll tax deposit and recordkeeping burdens facing small firms. One means of accomplishing this objective would be to permit a business with Federal payroll tax deposits of $5,000 or less to make such deposits on a once-a-month basis with a Federal depository (i.e., an institution which collects payroll tax deposits on behalf of the IRS).

Regulatory Flexibility Act

The Regulatory Flexibility Act (RFA) is designed to ensure that Federal agencies take into consideration the impact of their regulatory actions on small business. Before promulgating a regulation, RFA requires a federal agency to conduct an impact analysis as to the relative burden of that regulaton on small business.

Since its enactment, the IRS has considered itself exempt from the provisions of the Act. Accordingly, NSPA suggests that

Congress extend the RFA to all IRS and Treasury Department rulemaking, including interpretative rules.

The NWRA has been an advocate for the development of this nation's precious water resources and has worked closely with Congress, the Department of Interior, the Corps of Engineers, and other federal agencies with respect to water development policy and specific project authorization. Recognizing the changing political and financial environment with respect to federal financing of water projects, the NWRA early supported a shift in policy to require cost sharing at the local level in the development of water projects. The NWRA took this position with the full understanding that the state and local governmental units and other water development entities and users that it ultimately represents would be required to bear a substantial burden in financing water projects. The NWRA is proud of the leadership position it has taken on behalf of its members in supporting efforts at the federal level to fairly allocate the cost of water projects to those who primarily benefit from such projects.

As the responsibility to provide all or a portion of the financing for water projects has shifted to the states and their political subdivisions, those public bodies have become dependent on the capital markets to provide that financing. Furthermore, those public bodies are endeavoring to develop new credit and revenue sources and financing arrangements to support repayment of the debt that must be incurred to construct water projects since many of these projects, and particularly those supplying agricultural water, are not self-liquidating. A variety of financing ideas, including public/private partnership arrangements, are taking form to provide the needed capital to

STATEMENT OF
NATIONAL WATER RESOURCES ASSOCIATION
TO THE UNITED STATES SENATE COMMITTEE ON FINANCE
REGARDING H.R. 3838

Mr. Chairman,

The National Water Resources Association ("NWRA") is pleased to have this opportunity to submit its view to the Senate Finance Committee regarding certain provisions of H.R. 3838 which, if enacted in the form passed by the House of Representatives on December 17, 1985, would adversely impact the ability of many of NWRA's members to finance water resource recovery and distribution, as well as related hydroelectric generating facilities in certain instances (collectively referred to herein as "water projects.")

The National Water Resources Association began in the early 1930's as an association of western states faced with the common need to develop their water resources to meet the demands of a growing population. The NWRA has represented the interests of these states during its 54-year history and recently expanded its membership base and geographical coverage through an affiliation with the Groundwater Management Districts Association.

participate in cost sharing arrangements. The centerpiece of most of these arrangements is the ability of public bodies to access the tax-exempt market which for many years has provided low-cost capital for public benefit projects, even where a private entity was an incidental beneficiary.

At the very time when the burden of financing water projects has been shifted back to the states, we find that Congress is threatening to limit an important vehicle for providing that financing and tax-exempt bonds. The proposed revisions to Section 103 of the Internal Revenue Code found in H.R. 3838 and the adverse impact they would have on the efforts of members of NWRA to provide financing for water projects at the local level were addressed in a resolution adopted unanimously by the NWRA membership at its annual meeting in 1985. A copy of that resolution, number 85- 1 , is attached with this statement.

H.R. 3838 would effect a massive revision of Sectin 103 of the Internal Revenue Code as it relates to the issuance of tax-exempt bonds by state and local governmental units. While NWRA and its members believe that many of the proposed revisions are an affront to the federalist notion of comity between the states and the federal government and generally represent ill-advised financial and economic policy as applied to the states, we have restricted our comments to major flaws in the legislation as it applies to water project financing.

The NWRA respectfully requests that the Committee on Finance consider the following points in its deliberation on H.R. 3838:

A. Section 103 of the Internal Revenue Code provides currently that a bond will not be deemed an industrial development bond if not more than 25% of the proceeds are used in the trade or business of a non-exempt person. H.R. 3838 would, in effect, reduce the participation of non-exempt parties to the lesser of 10% of the proceeds or $10 million.

The so-called "25% rule" has been a valuable instrument in forging public/private partnerships where the credit of a private party can be harnessed to support the financing of a public benefit project. The fact that theprivate party may be an incidental beneficiary of low-cost tax-exempt financing would seem appropriate consideration for the private party's credit participation in a project, thereby enhancing the project's feasibility.

The proposed revisions contained in H.R. 3838 potentially would render meaningless public/private partnerships, as described above.

B. Current law provides that tax-exempt bonds may be issued to construct facilities for the furnishing of water, including irrigation water. Such facilities, even though owned and operated by private parties, have been deemed to provide a public benefit and tax-exempt bonds issued to finance these facilities have been accorded "exempt activity" status as an exception to the industrial development bond rule.

The proposed changes to Section 103 would restrict tax-exempt financing to those water furnishing facilities that are governmentally owned and are either operated by a governmental unit or for which rates are governmentally established. In addition, it would prohibit the issuance of bonds for irrigation systems.

The NWRA believes that the proposed revision does not reflect the reality that many water systems that provide public benefits are owned and operated by private parties and that private support of water projects will be increasingly important as the federal government reduces the involvement in water project financing. In addition, NWRA finds the provision eliminating altogether tax-exempt financing for irrigation systems to be particularly onerous at a time when the nation's farm economy is depressed. The provisions relating to water project financing are particularly difficult to understand as a matter of policy since H.R. 3838 would appear to allow for the tax-exempt financing of sewage or solid waste disposal facilities owned or operated by nongovernmental persons.

C. The NWRA believes that the provisions of H.R. 3838 requiring that 5% of net bond proceeds be spent within 30 days after issuance, that 100% of net proceeds be spent by no later than three years after issuance, and that proceeds related to "acquisition" would get only a 30-day temporary period fails to recognize reality with respect to the timing and phasing of construction and equipment acquisition involved in a major water project. We recognize that these provisions have been commented on extensively by a large number of other affected parties, and we wish only to add our concern regarding the unworkability of these provisions.

D. The NWRA believes that the arbitrage rebate requirements of H.R. 3838 are unfair and create a subsidy from principal issuers to the Treasury. Since H.R. 3838 requires that bond "yield" be calculated without regard to costs of issuance, the bond yield does not reflect the true cost of money to the issuer. However, under the rebate requirements of H.R. 3838, investment earnings on reserve funds and sinking funds generally must be rebated to the Treasury if those investment earnings exceed the "yield" on the bonds. Consequently, the return that issuers may earn under the rebate rules would be less than their actual cost of money. The result of this provision is to require large bond issues and greater cost to the public for water projects.

E. H.R. 3838 prohibits the advance refunding of all "nonessential" function bonds and severely restricts the advance refunding of "essential" function bonds. The NWRA believes that these provisions are detrimental to the abilityof state and local governmental units to employ sound debt management practices for the benefit of the public by being able to recost their debt during periods of favorable market conditions. Furthermore, since advance refundings provide the federal government with a cheap source of borrowing as a result of the arbitrage rules which require that advance refunding proceeds be invested in State and Local Government Series Obligations ("SLGS") at not in excess of the yield on the refunding bonds, we question whether this debt service savings to the federal government has been considered.

F. The NWRA is opposed to those provisions in H.R. 3838 which would increase the cost of borrowing for water project issuers. H.R. 3838 increases the cost of borrowing by disallowing interest expense incurred by financial institutions allocable to tax-exempt obligations carried by the financial institutions. Furthermore, H.R. 3838 generally would include interest on tax-exempt "nonessential" function bonds issued after December 31, 1985 as a tax preference item in calculating the alternative minimum tax imposed on individuals and corporations. Likewise, the provision requiring property and casulaty insurance companies to reduce their deductions for losses incurred by 10% (increasing to 15%) of the amount of tax-exempt interest received on accrued, as well as the imposition, beginning on January 1, 1988, of an alternate income tax based on adjusted net gains from operations (which would include tax-exempt income), will materially increase the cost of borrowing for water project issuers.

G. Finally, the NWRA questions the use of a volume cap based on an arbitrary formula tied to population. Major water projects which benefit a large number of people in a wide geographical area may be situated in states with relatively small populations. Should the bonds for such a project be deemed "nonessential" because of the participation of private parties, although that participation may be small in comparison to the total project (i.e., the lesser of 10% or $10 million), tax-exempt financing would be practically unavailable, and the ultimate cost of theproject to the public would be increased significantly.

The NWRA strongly opposes changes in Section 103 of the Internal Revenue Code which would increase the burden on state and local governments andother water project developers who are struggling to finance their share of water projects under the federal government's new cost sharing arrangements. We believe that the impact of the proposed new rules on state and local government would be detrimental to economic development and the efforts of local governments to provide local financing for such needed water projects.

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Congress Should Reform Tax Subsidies That Waste Agricultural Resources

Statement of the Natural Resources Defense Council on Tax Legislation in the 99th Congress

submitted to the

Committee on Finance, United States Senate

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The Natural Resources Defense Council (NRDC) welcomes the rise of tax reform to the top of the national legislative agenda. We agree that it is time to reexamine the piecemeal, almost random fashion in which the current Internal Revenue Code favors certain types of economic behavior at the expense of others in our society, and to reform the code to reflect a simpler, and more equitable, approach.

As a nationally based organization with a particular interest and expertise in the environment, NRDC[1] urges this committee, and the full Congress, to examine those aspects of the tax code that operate to encourage poor stewardship of our country's rich but vulnerable base of agricultural resources. Too often, the code seems to penalize rather than reward those who would take good care of the elements fundamental to long-range food and fiber production and a high quality rural environment. This statement briefly recites some of the most troubling natural resource problems in American agriculture, outlines some of the unfortunate contributions of the tax code to those problems, and recommends a set of specific reforms, many of which have already taken shape in proposed legislation.

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[1] NRDC is a national non-profit membership corporation with more than 55,000 members and contributors, dedicated to the preservation, enhancement and defense of the natural resources of the United States and the world. Through the efforts of its agriculture project, NRDC supports the maintenance and improvement of the productive capacity and soils of our nation's valuable agricultural lands.

The Silent Crisis in Rural America

The most critical environmental problem in rural America is soil erosion, which portends major future reductions in crop yields if current trends are not reversed. Informed estimates indicate that at least one-tenth of the land being farmed intensively today is so marginal that nothing short of permanent retirement will protect it;[2/] a much larger fraction is more tractable but nevertheless eroding at rates that exceed tolerable levels. An alarmingly large share of the problem is concentrated in our most productive farming regions. Over half the cropland in the Corn Belt states of Illinois, Indiana, Iowa, Missouri and Ohio, for example, is considered to be in need of erosion control treatment.[3/]

Another limited resource at risk from modern agriculture is ground water, which in some areas is being rapidly depleted by irrigation. According to recent reports of the Council on Environmental Quality, a majority of states are experiencing moderate to critical overdrafts of aquifers and, indeed, 25 percent of all ground water withdrawals are occurring at rates

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[2/] *See* American Farmland Trust, *Soil Conservation in America: What Do We Have to Lose*, Washington, D.C. 109-111 (1984).

[3/] USDA Soil Conservation Service, 1982 National Resources Inventory National Summary, Tables 9a, 10a and 25a (July 1984).

faster than natural recharge capabilities.[4] Ground water "mining" is especially acute in the High Plains, southern Arizona and California.[5]

Moreover, environmental problems in agriculture often extend beyond the farm. Agriculture is recognized, for instance, as the leading cause of nonpoint source water pollution,[6] costing billions of dollars annually in flooding, lost recreational opportunities, and damages to water storage and treatment facilities.[7] Agriculture also is responsible for 80 percent of wetland conversions in the U.S.; these vanishing ecosystems provide critical wildlife habitat, recharge underground aquifers and enhance surface water quality.[8] Around three-fourths of the prairie wetlands of Iowa, Minnesota and the Dakotas have been lost since the region was first settled.[9]

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[4] U.S. Council on Environmental Quality, Environmental Quality 1979 83-84 (1980) (11th Annual Report of the CEQ); Environmental Trends 215 (1981).

[5] U.S. Council on Environmental Quality, Environmental Quality 1983 86-88 (1984) (14th Annual Report of the CEQ).

[6] U.S. Environmental Protection Agency, Report to Congress: Nonpoint Source Pollution in the U.S. 4 (January 1984).

[7] See E.H. Clark II, et al., Eroding Soils: The Off-Farm Impacts, The Conservation Foundation 175 (1985).

[8] U.S. Office of Technology Assessment, Wetlands: Their Use and Regulation 3, 37-65 (March 1984).

[9] E.B. Podoll, "Prairie Wetlands: Home for Over 100 Species," in Using our Natural Resources 257 (USDA 1983 Yearbook of Agriculture).

The Role of Tax Policy

Unfortunately, the current tax code contains provisions that are directly at odds with the need to solve these problems. For example:

- A speculator who purchases rangeland and converts it to cropland, even though the conversion results in severe rates of erosion, profits in two ways: first, from the increased market value of the land resulting from its conversion; second, from generous capital gains treatment that exempts from taxation 60 percent of any income that accrues from the sale of the property.[10/]

This tax shelter creates a powerful incentive for sodbusting and a powerful disincentive to keeping the land in its environmentally preferred use as rangeland. The problem is particularly acute on previously uncultivated land with features that make it highly susceptible to destructive "plowout."[11/] Continued tax subsidies for sodbusting are plainly inconsistent with the conservation title of the 1985 farm bill, and threaten to dilute or even nullify that law's positive effects.

[10/] *See* M.J. Watts, *et al*., "*Economic Incentives for Converting Rangeland to Cropland*" (November 1983) (Cooperative Extension Service, Montana State University, Bulletin 1302).

[11/] Data from the 1982 National Resources Inventory indicate that, across the U.S., over 70 million acres of marginal land in SCS capability classes IIIe, IVe, VI, VII and VIII have high or medium potential for conversion from forest or grass cover to cropland.

- Any farmer who drains a wetland for purposes of rowcrop production is able to deduct all expenses for land clearing and related manipulations. The existing tax code thus also contravenes the "swampbuster" provision of the new farm bill, which is designed to discourage the agricultural destruction of wetlands.

- With respect to the Ogallala Formation, a system of aquifers underlying a vast 220,000 square mile area in the Great Plains, the IRS's "Farmer's Tax Guide" explicitly allows a generous deduction "when it can be demonstrated that the groundwater is being depleted and that the rate of recharge is so low that, once extracted, the groundwater is lost to the taxpayer and immediately succeeding generations."12/ This is a particularly troubling statement of public policy for a region that accounts for nearly half the nation's irrigated land.13/

Needed Reforms

New initiatives are needed to redress glaring policy contradictions such as these, and important steps toward that end have already been taken in pending legislation. Our recommendations are essentially fourfold.

12/ U.S. Department of the Treasury, Internal Revenue Service, Farmer's Tax Guide 26 (October 1984) (IRS Publication 225).

13/ H. Bouwer, et al., "Our Underground Water Supplies: the Sometimes Dry Facts," in Using our Natural Resources 451 (USDA 1983 Yearbook of Agriculture).

-- S. 1786: The Cultivation of Highly Erodible Lands and Wetlands Tax Act

We offer enthusiastic support for S. 1786, legislation introduced by Senators Boren and Grassley to remove tax incentives for sodbusting and swampbusting. In particular, S. 1786 would withdraw capital gains treatment from income generated by the sale of agricultural land when the property involved is highly erodible land or wetland that the taxpayer has converted to cropland. In addition, the bill would deny tax credits and deductions taken in connection with such conversions.

These actions would both reflect sensible natural resource policy and reverse a longstanding pattern of excessive federal revenue losses. Indeed, Senator Boren, upon introducing this legislation, noted that the cumulative magnitude of tax subsidies, ranging from deductions of interest payments to investment tax credits, can far exceed $100 per acre, liberally rewarding those who plow fragile grassland or drain wetland for purposes of rowcrop production.[14]

We especially favor the coverage of S. 1786 with respect to deductions and credits. Section 921 of H.R. 3838, the comprehensive tax reform bill recently approved by the House of Representatives, takes a different and, in a sense, narrower approach than S. 1786: the House bill would repeal deductions only for land clearing expenditures on previously uncultivated land and for multi-year fertilizer and soil conditioning inputs, irrespective of the quality of the land being farmed or brought into farming. The two bills are not necessarily inconsistent, and there may be good non-environmental arguments for retaining the House provisions for most farmland. Nevertheless, where highly erodible land and wetland are concerned, the broader language of S. 1786 should be adopted.

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[14] See W.A. Laylock, "Plowing of Fragile Grasslands in the Northern and Central Great Plains," in Proceedings, The Range Beef Cow Symposium VIII 73 (December 1983).

We believe S. 1786 could benefit from certain technical modifications. We recommend, for example, that the bill incorporate applicable language from the 1985 farm bill, notably the definitions of "highly erodible land" and "wetland" (Food Security Act of 1985, P.L. 99-198, Sec. 1201). Senator Boren indicated support for this approach in his introductory remarks.

We urge also that S. 1786 reshape some of its exemptions to the rules restricting tax benefits for conversions of highly erodible land or wetland to cropland. In particular, the bill should create separate sets of exemptions for highly erodible land and for wetland in a manner sensitive to the special needs of each category. A useful model in this regard is provided by Sections 1212 and 1222 of the farm bill, which specify exemptions to that law's "sodbuster" and "swampbuster" provisions, respectively. For example, the farm bill appropriately contains an exemption for highly erodible land that is managed under an approved conservation system but does not contain a similar exemption for wetland, for which conservation needs are generally incompatible with conversions to crop production.

We also recommend a technical amendment to the language of S. 1786 that exempts from the bill's operative provisions any highly erodible land or wetland that does not constitute "the predominant class of land comprising the total farming unit." We support the apparent intent of this exception to prevent the arbitrary denial of tax benefits when insignificant amounts of fragile land are converted. As drafted, however, the exception may also open the door to tax-subsidized destructive conversion of sizable acreages -- even entire fields -- of highly erodible land or wetland, particularly where the "total farming unit of land" is a large agricultural operation.

The farm bill's "sodbuster" provision (P.L. 99-198, Sec. 1211), takes a more precise approach by denying federal agricultural program benefits for new, non-conserving crop production on any "field," as defined in the farm bill, "in which highly erodible land is the predominant class."[15] Similar language would be preferable for the tax legislation.

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[15] Section 1201(a)(7)(B) of the farm bill directs USDA to determine through the regulatory process how the "predominant class" test for highly erodible land is to be administered on a field-by-field basis. Section 1201(a)(5) of the law adopts a definition from the Code of Federal Regulations wherein "field" basically means a discrete portion of a farm made separate from the remainder of the whole unit by fences or other permanent boundaries.

-- Limits on deductions for soil and water conservation

Any comprehensive tax legislation passed by the Senate should include a companion to Section 922 of H.R. 3838. Applicable to all cropland, this measure would limit the expensing of soil and water conservation investments, currently allowed under Section 175 of the Internal Revenue Code, to those expenditures that are consistent with a plan approved by the Soil Conservation Service (SCS) or a "comparable State agency."[16] Such a provision would help ensure that, where conservation deductions are allowed, the public gets tangible conservation benefits instead of merely amenity values or production enhancement for the farmer. Our only technical recommendation here is that the tax legislation should match the farm bill by designating local conservation districts as the lead agents of conservation plan approval pursuant to technical standards established by SCS.

-- Limits on tax benefits in environmental zones

We support S. 1839, Senator Chafee's bill to deny most special tax deductions and credits for development in

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[16] Regardless of whether a conservation plan is in effect, H.R. 3838 would permit no deductions for "conservation" expenditures associated with the draining and filling of wetlands or the preparation of land for center pivot irrigation systems. We also endorse this feature of the House bill.

"environmental zones."[17] These zones are identified on the basis of federal laws that favor retention of natural conditions in such areas. The restrictions of S. 1839 would apply, for example, where agricultural development is incompatible with the need for critical habitat protection under the Endangered Species Act.

However, limited exceptions should be allowed to S. 1839's near-wholesale proscription of tax benefits in environmental zones where it can be demonstrated that such benefits serve an environmentally beneficial purpose. For example, certain soil and water conservation deductions may be appropriate in environmental zones when they are taken on expenditures for reclaiming an area disturbed by farming or other reversible development activity; tax benefits for sustained yield forestry may be desirable in environmental zones where the probable alternative is leaving cutover areas unregenerated.

In addition, the definition of environmental zone might be enlarged to encompass the protection of prime farmland from irreversible non-agricultural development. This would be consistent with the Farmland Protection Policy Act, which affirms a national recognition that our land best suited for sustained agricultural production should be conserved.[18] We would be pleased to work with the committee in elaborating this idea, in either S. 1839 or a separate vehicle.

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[17] NRDC's views on S. 1839 have already been outlined in a joint statement with the National Wildlife Federation presented at a January 31, 1986 hearing before the Senate Committee on Finance.

-- Repeal of the water depletion allowance

Congress should eliminate the water depletion allowance, which serves no purpose other than to subsidize the excessive withdrawal of ground water. No pending legislation addresses this problem, which is not explicitly a creature of the tax code itself, but appears to derive from an Internal Revenue Service ruling. The ruling unwisely lumps water with oil, gas and geothermal deposits, which are specifically referenced in federal tax laws.

Conclusion

For agricultural resources, the deliberations of Congress on tax reform afford a golden opportunity to harmonize the Internal Revenue Code with federal conservation laws and policies, particularly those set in place by the 1985 farm bill. We applaud the progress Congress has already made toward this end, and are hopeful that the new tax reform law will emerge this year with meaningful reductions in subsidies for destructive agricultural land management.

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[18] Farmland Protection Policy Act, as amended, U.S. Code, vol. 7, sec. 4201, et seq.

The Act begins with a congressional finding that "the Nation's farmland is a unique natural resource and provides food and fiber necessary for the continued welfare of the people of the United States." The leading purpose of the law is "to minimize the extent to which Federal programs contribute to the unnecessary and irreversible conversion of farmland to nonagricultural uses."

Finally, we should note that this statement has been confined to those aspects of federal tax policy that most clearly clash with conservation objectives in rural America. We have not delved into possible hidden resource impacts of more general features of the revenue code, from tax rates to depreciation schedules to cash accounting. Nevertheless, we urge the Senate, in shaping its comprehensive tax reform package, to consider all issues with an eye toward resource conservation and environmental protection. We stand ready to assist in this endeavor.

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STATEMENT OF THE
GOVERNMENT OF THE NETHERLANDS ANTILLES
SUBMITTED TO THE
COMMITTEE ON FINANCE
OF THE UNITED STATES SENATE

Relating to the Hearings on Economic Effects of H.R. 3838 on International Competitiveness and Capital Formation, Commencing January 29, 1986

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The purpose of this statement is to express our concerns about the provisions in H.R. 3838 which would (i) override United States treaty obligations to the Netherlands Antilles, (ii) cause harm to the Netherlands Antilles economy at a time of economic decline and contrary to recent U.S. commitments to foster the Netherlands Antilles economy in our tax relations, and, we submit, (iii) harm the broader national interest of the United States. The notion that U.S. treaty obligations should be overridden unilaterally and selectively, and without regard to the economic effects and the impact on U.S. foreign relations, in order to permit the immediate implementation of changes in U.S. tax policy has surfaced in 1984 Internal Revenue Service revenue rulings (Rev. Rul. 84-152 and Rev. Rul. 84-153), was supported in several Congressional staff documents, and is again manifest in certain provisions of H.R. 3838. The common theme in those various instances is that unilateral override by the United States of a tax treaty provision is acceptable in order to immediately carry out the newly developed concept that third country use of tax treaties (or "treaty shopping") shall be denied.

Your Government has undertaken the courageous and massive task of reforming the U.S. tax system and it is not our role to comment upon the tax policy goals of the United States. However, we believe that, in making the difficult decisions that lie ahead, your Committee, and Congress in general, may find it useful to understand the views of a treaty partner, also a long-standing ally and friend of the United States, on how your decisions will impact not only the treaty process but also the position of the United States as a country willing to fulfill its international obligations and how they will deeply affect our economy and stability to the detriment of both our countries. Indeed, a review of the material publicly available suggests that the House Ways and Means Committee did not properly focus on the issues of legislation contrary to international obligations and the effect on the economy and stability of the Netherlands Antilles.

The U.S. Government has traditionally defended policies designed to encourage free enterprise and free trade both at home and abroad as a basis for self-sustaining economic growth. This Administration, as a particularly strong advocate and defender of the free trade and free enterprise philosophy, has encouraged the implementation of foreign and economic policies which clearly reflect those beliefs. U.S. tax treaties provide an essential support to carry out those policies at an international level and play an important role in promoting international trade and investment both from and within the United States. Overriding tax treaties in the manner set forth in the bill as passed by the House would seriously undermine their effectiveness in carrying out those important goals and may earn the U.S. a reputation as an unreliable nation unable to live up to its international obligations.

While we understand that the United States has legitimate concerns regarding the use of tax treaties by third country residents, the attempt to deal with this issue unilaterally in H.R. 3838 would constitute "overkill." Treaty override would result in more detriments to the United States and its treaty partners, particularly the Netherlands Antilles, than benefits which are, in reality, timing benefits, given the ability of the United States to develop its tax policy goals over time through the treaty negotiation process. From the point of view of revenue, the Report issued by the House Ways and Means Committee to accompany H.R. 3838 indicates that the revenue to be generated from the branch tax, which is the principal provision involving treaty override, is estimated at only $145 million over a five-year period.

The Objected-to Provisions Included in H.R. 3838

Several provisions of H.R. 3838 conflict with existing U.S. tax treaties. In resolving those conflicts, the House has singled out for override those treaties which have been identified as permitting "treaty shopping," including that between the United States and the Netherlands Antilles.

We are referring especially to section 651 of H.R. 3838 which would impose a branch tax on the income of U.S. branches of foreign corporations unless reinvested in the United States and on certain interest expense of such branches. This tax would replace the existing second-level withholding tax now imposed on certain interest and dividends paid by foreign corporations which derive a majority of their gross income over a 3-year base period from a trade or business in the United States. However, the branch tax would apply more broadly than the second-level withholding tax because H.R. 3838 would eliminate the 50% gross income threshold so that the branch tax would apply to all income and certain interest expense of foreign companies to the extent the income is effectively connected with a U.S. trade or business and the interest expense is allocable to such income and paid to certain categories of foreign persons.

If enacted, the branch tax would conflict with, at least, the purpose of Article XII of the U.S.-Netherlands Antilles income tax treaty which provides that the second-level withholding tax (for which the branch tax would be a substitute) does not apply to dividends and interest paid by a Netherlands Antilles corporation to a non-U.S. person. Also, it would directly conflict with the nondiscrimination protection of Article XXV(3) which provides that a Netherlands Antilles corporation should not, while resident in the United States, be subject to more burdensome U.S. taxes than are U.S. corporations. While section 651 of H.R. 3838 addresses the conflict with tax treaties, it resolves it in a manner that violates international law and is discriminatory against the Netherlands Antilles. Generally, the bill would place U.S. tax treaties in three categories: treaties which permit the imposition of a branch tax; treaties which do not permit the imposition of a branch tax, but permit the imposition of a second-level withholding tax; and treaties which prohibit both the second-level withholding tax and a branch tax. Only tax treaties in the latter category (which includes the treaty with the Netherlands Antilles) would be subject to the special treaty override rule under the bill. The treaty override rule provides that the branch tax overrides any inconsistent treaty provisions for any treaty country corporation which is not at least 50% owned by residents of that treaty country (or which is not primarily and regularly traded on an established securities market in the treaty country). In contrast, treaties in the second category (which do not permit a branch tax but permit a second-level withholding tax) would continue without override regardless of third country ownership of the corporations in those treaty countries. This would be a substantial advantage granted to those corporations especially where the treaty reduces the rate of the second-level withholding tax and/or maintains or raises the 50% income threshold. Since the Netherlands Antilles, starting just before World War II and with active encouragement by the U.S. Treasury in the 1960's and early 1970's (and the implicit encouragement in the late 1970's and early 1980's), has developed an international financial sector serving investors from all over the world and does not have a stock exchange, this treaty override provision affects it significantly and is especially harmful to its economy.

In addition, to the branch tax, there are other provisions with similar treaty override effects. Section 231 of H.R. 3838 would impose a new special withholding tax of 3.6% on the dividends paid to foreign shareholders of U.S. corporations. Under the bill, this tax is scheduled to override U.S. tax treaties starting in 1989, except for treaties which have adequate provisions to prevent treaty shopping, as certified by the Treasury. While the Netherlands Antilles hopes to have a new treaty with the United States in place before 1989 which will be accepted as adequately preventing treaty shopping, it is not clear that this will be possible given the various pressures on the priorities of the U.S. Treasury. As a result this would be an unjustified override of our tax treaty. Moreover, the Committee Report indicates that the new source rules are to override treaties for purposes of applying the U.S. foreign tax credit.

The Proposal Fails to Respect International Law Which Requires That Treaty Obligations Not be Unilaterally Terminated

The branch tax proposal represents a legislative and unilateral termination of Article XII (and Article XXV(3)) of the existing U.S.-N.A. income tax treaty and is contrary to basic principles of international law requiring treaty obligations to be respected. Further, the proposal unduly interferes with an ongoing treaty negotiation process between our two countries and which the Netherlands Antilles is pursuing in good faith. These negotiations are attempting to resolve all the tax treaty issues, including the "treaty shopping issue" and Article XII, in a manner that requires compromises on both sides in order to reach a mutually beneficial relationship for the future, including a comprehensive exchange of information package. The branch profits tax proposal seriously jeopardizes these negotiations.

Further, in our view, the concept of treaty shopping, a principal target of this proposal, is better handled in the context of tax treaties than by legislation. It is the view of the U.S. Treasury, itself, that anti-treaty shopping provisions should be tailored to the needs of each treaty because they depend on the "effective tax burden" in the other Contracting State.[1] The anti-treaty shopping rule under H.R. 3838 takes a simplistic approach denying tax treaty benefits where they are appropriate and, possibly, permitting them where inappropriate.

The United States has undertaken international obligations in matters of taxation vis-a-vis the Netherlands Antilles knowingly and willingly. First in 1955 when the U.S.-Netherlands income tax treaty was extended to the Netherlands Antilles and again in 1963 and 1964 when a new Protocol limiting the scope of the treaty as applicable to the Antilles was negotiated and ratified. This Protocol deals with the use of the U.S.-N.A. income tax treaty by third country residents, prohibiting it in some cases and allowing it in other cases. H.R. 3838, as passed by the House, would substantially change the balance that was agreed to at that time. In good faith, the Netherlands Antilles has relied on this U.S. agreement. We accept that tax policy goals must evolve with changed circumstances, but that is the purpose of the treaty negotiation process. Both as a matter of morals and international law, a unilateral override to effect changes in policy is plain wrong. When the U.S. Treasury testified before Congress in relation to the enactment of the Foreign Investment in Real Property Tax Act of 1980 (FIRPTA), it properly noted that:

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[1] Mr. John E. Chapoton, then U.S. Treasury Assistant Secretary for Tax Policy, Hearing before the House Subcommittee on Commerce, Consumer and Monetary Affairs, 98th Cong., 1st Sess., April 12 and 13, 1983, p. 260, 261.

> "The process of negotiating and ratifying a tax treaty is long and arduous. This process would be rendered all the more difficult, if not altogether impossible, if the United States were to begin overriding specific treaty provisions that a foreign country had negotiated in good faith. However, most of our treaty partners are sympathetic to considering treaty changes necessary to prevent tax evasion and unintended tax avoidance. Accordingly, we are opposed to any statutory changes which would immediately override our tax treaty obligations, but are willing to contemplate provisions which would allow the Treasury sufficient time to implement appropriate modifications in those treaties before statutory changes become effective."[2]

We could not concur more with this statement which is appropriate for the 1980's just as it was appropriate for the 1970's.

The Vienna Convention on the Law of Treaties, which is generally accepted as setting forth the customary international law on treaties, provides in Article 26 that: "Every treaty in force is binding upon the parties to it and must be performed by them in good faith." The binding obligation of a treaty is not overcome for purposes of international law by the unilateral legislation of one of the Contracting States, as the legal scholars of the American Law Institute have recognized.[3] We understand that under the Constitution of the United States, treaties and statutes have equal status and a subsequently enacted statute would prevail over a prior treaty. However, as recognized by your American Law Institute, this purely domestic law principle does not excuse what would remain a violation of international law.

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[2] Mr. Donald C. Lubick, then U.S. Treasury Assistant Secretary for Tax Policy, Hearing Before the House Ways and Means Committee, Taxation of Foreign Investor Direct and Indirect Ownership of Property in the United States, 96th Cong. 1st Sess., October 25, 1979, p. 7.

[3] Restatement (Revised) of the Foreign Relations Law of the United States §135(1)(b) (Tent, Draft No. 6, 1985).

The proposals in H.R. 3838 undermine the credibiity of the United States as a reliable treaty partner with possible repercussions beyond the Netherlands Antilles and beyond tax treaties. How can the United States effectively object to violations of SALT, human rights, and trade treaties at the same time the United States unilaterally overrides its own treaty obligations (in order to accelerate changes in tax policy).

The House bill appears to recognize that treaties create obligations, but with a measure of schizophrenia. The Report of the House Committee on Ways and Means on H.R. 3838 states the Committee's intent "that this bill be interpreted so as not to conflict with the policy embodied in treaties where possible so that the policy goals of both treaties and this bill can be carried out." The Committee has felt compelled to include selective overrides in a move that affects the Netherlands Antilles more than any of the other U.S. tax treaty partners and which makes those overrides particularly discriminatory and totally unjustifiable under generally recognized international legal principles.

To our knowledge, there are no compelling reasons for the United States to ignore its obligations toward the Netherlands Antilles. Our two countries have traditionally been close allies, dating back to the U.S. Revolutionary War and World War II and we have previously testified about the many occasions in which our country has been of strategic help to the United States in periods of crisis. Moreover, we are in treaty negotiations and in the process of sorting out a joint agreement on "treaty shopping."

Effect of the Treaty Override on the International Financial Sector of the Netherlands Antilles

In addition to objecting to treaty override as a matter of principle and international law, we must object as a matter of economics. One of the major effects of the branch tax would be to substantially increase the U.S. taxation of foreign real estate investment in the U.S. Since much of this investment is made by Netherlands Antilles companies, the international financial sector of the Netherlands Antilles would be directly affected. Also, certain other investments, where N.A. companies are directly engaged in U.S. trade or business, would be hurt.

Indeed, the proposed branch tax together with other changes proposed in H.R. 3838 would make the tax costs of foreign investment in U.S. real estate by means of Netherlands Antilles companies so prohibitive that investors would either lose interest in U.S. real estate or consider the possibilities of ameliorating the U.S. tax through other, non-Antillean, means.

The Netherlands Antilles has developed an important international financial sector heavily dependent upon its tax treaty relationship with the U.S. As stated, this sector was fostered, first explicitly and then implicitly, by the U.S. Treasury Department from 1963 to 1984 to help facilitate access to the Eurobond market by U.S. corporations. Because of the Eurobond activity, real estate activity, and other activity, this sector has become one of the pillars of the Netherlands Antilles economy. In 1984, the U.S. repealed its withholding tax on portfolio interest, making the Netherlands Antilles route unnecessary for Eurobonds, but, as described below, this was done with an effort to cushion the adverse impact on the Netherlands Antilles over time, dependent on the maturities of the pre-repeal Eurobond issues through the Netherlands Antilles.

Thus, the Netherlands Antilles is in the position of trying to maintain its international financial sector as a meaningful (and necessary) contributor to its economy while the mainstay of that sector, the Eurobond activity phases down, and in this effort real estate is crucial as the next most important activity in that sector.

The importance of the international financial sector to the Netherlands Antilles is reflected in the fact that that sector now furnishes approximately $258 million in tax revenues which constitutes some 44% of the combined Central Government-Curacao tax receipts at a time when the overall revenue needs of our country have required the imposition of an income tax surcharge. In addition, the foreign exchange activity and the direct and indirect employment effort of the international financial sector in Curacao is significant. While the revenue, foreign exchange, and employment from the international financial sector will decrease over the next several years as the pre-repeal Eurobond issues mature (or are called prior to maturity), it is our hope that the international financial sector can continue with real estate and other activities at a level, which, while reduced, will still help our economy.

Out of necessity, we are adapting to the inevitable disruption resulting from the U.S. policy decision to repeal the interest withholding tax, and we believe that the international financial sector can remain viable, albeit at a reduced level, but not if the real estate sector and the smaller number of other investments involving a direct U.S. trade or business by N.A. companies are also harmed by a direct and unnecessary attack of the type reflected in the branch tax proposal. The effect of the decline of our international financial sector on our economic, social and political balance is worsened by the recent closing of the Exxon oil refinery in Aruba and the drastic contraction of the Shell refinery in Curacao. Those events have caused significant loss of jobs and will have a further adverse effect on Government revenues.

Thus, the real estate part of the international financial sector has assumed even greater importance. This sector impacts local economic activity in the form of increased employment, taxable earnings of local enterprises attending to the needs of those companies, improved balance of payments, and a "pull-effect" fostering higher education and the development of a more sophisticated information structure. The importance of real estate companies to the Netherlands Antilles is evident from statistics compiled by the U.S. Department of Commerce. According to those statistics, total foreign-owned U.S. real estate amounted to almost $17 billion in 1984, of which more than 21% was owned by Netherlands Antilles companies. Thus, the Netherlands Antilles is the second largest investor in U.S. real estate, behind the United Kingdom, whose investors own almost 24% of total foreign-owned U.S. real estate. Further, according to the same statistics, investments by Netherlands Antilles companies in U.S. real estate represent two-thirds of the total direct investment capital inflow from Antillean companies for 1984. Thus, it is clear that real estate companies account for a very substantial portion of what is left of our international financial sector and must be present for that sector to endure.

The Branch Profits Tax Override Would Add to Other U.S. Actions Detrimental to the Netherlands Antilles International Financial Sector

When we testified before the House Ways and Means Committee about 18 months ago on another matter, the uncertainties resulting from protracted negotiations of the U.S.-N.A. income tax treaty had somewhat eroded our international financial sector but the principal elements supporting its viability were still in place. Since then, we have suffered from the repeal of the withholding tax on interest, a continued hostile attitude by IRS and Treasury including the issuance of two revenue rulings on October 15, 1984, which throw substantial doubt on the applicability of the existing treaty, and must now face a branch tax proposal which would, in effect, unilaterally repeal key provisions of our treaty.

The repeal of the U.S. withholding tax on interest has been mentioned above and the Congressional policy with regard thereto is discussed below.

Without any notice to the Netherlands Antilles, on October 15, 1984, the U.S. Internal Revenue Service issued two revenue rulings -- Rev. Rul. 84-152 and Rev. Rul. 84-153. Our Government has made constant efforts to convince the U.S. Treasury to ameliorate these rulings which are questionable both under U.S. tax principles and international law. The only result of these efforts so far has been a 1985 revenue ruling by the IRS providing that the 1984 rulings would apply prospectively only. While this announcement is of help to investors that have used the Netherlands Antilles for past transactions, it is of no help to the current economic situation in the Netherlands Antilles and, indeed, by implying confirmation of the 1984 rulings, the 1985 ruling is harmful to our economy.

Certain members of Congress have been sufficiently alarmed by those rulings to write to the Treasury Department, setting forth their views on the intent of the repeal legislation to create a direct route to the Eurobond market and not to interfere with transactions covered by the existing U.S.-Netherlands Antilles income tax treaty. The letters, accordingly, call for the reconsideration of the revenue rulings. However, ignoring his contrary assurances before the Ways and Means Committee on May 1, 1984, then Assistant Secretary Pearlman responded to the members' letters, in letters dated August 1, 1985, that after repeal there is no longer a legal or policy basis for recognizing financing transactions through the Netherlands Antilles and concluded that the rulings were justified.

The Treaty Override Provisions in H.R. 3838 are in Conflict With Congressional Policy

Over the years, Congress has generally recognized the need to balance the goals of U.S. tax policy with those of U.S. foreign policy. The enactment of the Caribbean Basin Initiative in 1983 is a good example of the use of tax incentives to serve the needs of specific foreign policy goals of the United States in the Caribbean region, of which the Netherlands Antilles is a strategically critical part. Even more significant are the special grandfather provisions under section 127 of the Deficit Reduction Act of 1984, the express purpose of which was to mitigate the hardship to the Netherlands Antilles economy resulting from the repeal of the U.S. withholding tax on interest:

> "... Congress was concerned that repeal of the withholding taxes could have a substantial negative impact on the economy of the Netherlands Antilles. Because repeal of the 30-percent tax makes it unnecessary for U.S. corporations to route future borrowings through the Antilles, the use of the Antilles as a financial center is likely to be substantially reduced ... Congress was informed that offshore financing activities generate a large portion of the Antilles budget. Congress believed that, while offshore financings generally should be scrutinized closely by the IRS and tax treaties should not be used as a basis for establishing conduits whose existence results in a transfer of revenues from the U.S. Treasury, the Antilles should have some time to adjust to tax law changes that affect its economy.... Congress believed that a repeal of the 30-percent tax with prospective effect only would result in a gradual and orderly reduction of international financing activity in the Netherlands Antilles and thus

> mitigate any economic hardship that the withholding tax repeal might indirectly impose on that country."[4]

The Department of Treasury has expressed similar concerns during hearings before the House Ways and Means Committee on May 1, 1984, in relation to the repeal of the U.S. withholding tax. In response to a question from Chairman Rostenkowski whether the Treasury had considered the impact of the repeal on the economy of the Netherlands Antilles, Mr. Ronald Pearlman, then Deputy Assistant Secretary for Tax Policy, assured that the Treasury Department was "sensitive to the problem of the Netherlands Antilles" and was hopeful "that through the continued treaty negotiations and through the other efforts that hopefully this Government would make in dealing with the Antilles, [...] the effect [of the repeal of the withholding tax on interest] would be softened."[5]

As proposed, the branch tax would cause the same type of economic hardship to the Antilles economy as the U.S. Treasury and Congress precisely sought to mitigate in 1984. Yet, the tax, with its override of our treaty, is proposed with total disregard to its impact on our economy and, in effect, with the apparent purpose to finally undermine the existing treaty.

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[4] General Explanation of the Revenue Provisions of the Deficit Reduction Act of 1984, prepared by the Staff of the Joint Committee on Taxation, Dec. 31, 1984, pp. 392-393, the so-called Blue Book. (However, we question the comments on scrutinizing offshore financing and conduits as gratuitous Staff remarks without basis in Member statements.)

[5] 98th Cong., 2nd Sess., Serial 98-84, p. 38.

In 1984, for the reasons stated in the language quoted above, Congress was convinced that relief for the Netherlands Antilles economy was necessary in view of the impending repeal of the U.S. withholding tax on interest and as a result it made repeal inapplicable to existing international bond issues. In this instance, as the effect of the prior action dissipates, we urge Congress not to override our treaty. Such restraint would help avert serious disruptions in our social and political stability. Rather, we urge that the questions of third country use of tax treaties be dealt with in treaty negotiations with the goal that a balance be struck between the U.S. policy to restrict third country use on the one hand and the protection of the N.A. international financial sector and free movement of trade and investment on the other hand.

The United States Stands To Gain From Increased Cooperation With the Netherlands Antilles

By fully respecting its tax treaty obligations in enacting a branch tax, the United States will suffer no detriments since it is acknowledged that the proposal would raise only negligible revenues. In fact, by not taking the proposed action, the United States may stand to benefit in at least four ways. It would affirm, for all the world, the U.S. commitment to abide by its international obligations. Also, the United States would continue to attract foreign investors in U.S. real estate at a time when domestic real estate investments might be declining. Further, by helping the Netherlands Antilles to retain or even improve its current economic status, the United States would protect its alliance with a small but strategically located friend in the Caribbean region. Finally, by encouraging the conclusion of a new tax treaty with the Netherlands Antilles, the United States would benefit from greater access to information.

It is recognized that treaty-shopping is possible and probably conducted through a number of U.S. tax treaties negotiated prior to 1980, although it would appear that the United States substantially benefits from investments by non-treaty investors. While unfettered use of U.S. tax treaties by non-treaty residents may no longer be acceptable under current U.S. tax policy thinking, use by third country residents properly limited in the context of bilateral negotiations should be both acceptable and beneficial to both parties. This is particularly true in the case of investments in U.S. real estate. As stated earlier, almost a quarter of total foreign-owned U.S. real estate is owned by Netherlands Antilles companies, principally owned by investors who do not reside in treaty countries or who do reside in treaty countries but prefer to hold their investments outside their countries of residence. In fact, it must be assumed that treaty-shopping was part of the equation that led Congress in 1980 to impose a tax (FIRPTA) on gains realized by foreign investors on the disposition of their U.S. real property interests. Since Article XII of the U.S.-Netherlands Antilles income tax treaty waives the U.S. second-level withholding tax on dividends and interest, FIRPTA was adopted with the knowledge that the FIRPTA tax would, in most cases, be the only U.S. tax imposed on gains from U.S. real estate holdings of foreigners. Congress, at the time, undoubtedly understood and accepted third-country use, allowing FIRPTA gains to be taxed only once.

The main effect of the branch tax proposal in H.R. 3838 as an add-on to the FIRPTA tax would be to discourage the inflow of foreign capital into U.S. real estate for a wide spectrum of foreign investors at a time when such capital may be more desirable than ever. Many of the provisions in H.R. 3838 would make real estate investments less advantageous on an after-tax basis, causing many domestic investors to turn to more profitable and less speculative forms of investment, diminishing the amount of domestic capital available to the U.S. real estate industry and make foreign capital all that more important. Further, this would be occurring at a time when several urban areas in the United States are experiencing difficult market conditions, particularly in commercial real estate. In addition, the decline in U.S. farmland prices is adding to the mounting financial difficulties of the U.S. farming community and the enactment of the branch tax in its present form would discourage many foreign investors from helping the market to strengthen. Also, U.S. oil and gas investments by foreigners are subject to FIRPTA and would be subject to the branch tax, again cutting off needed foreign capital to an important and depressed sector.

The branch tax would be a strong deterrent to many foreign-owned U.S. real estate investments. In addition to the other provisions in H.R. 3838 which would increase the maximum corporate long-term capital gain rate from 28% to 36%, and increase the depreciation period for real estate from 19 to 40 years (or 30 years subject to the minimum tax), foreign investors in U.S. real estate would have to bear the additional burden of a branch tax for their U.S. real estate investments held by a Netherlands Antilles company. The combined effect of the corporate income tax and the branch tax would be to increase the maximum U.S. nominal tax to at least 55% on all gains and income from real estate holdings. In fact, the maximum effective tax rate may be higher than 55% if the branch tax, as it is now proposed, does not allow certain interest expense as a deduction from the base upon which the branch tax is imposed. Under H.R. 3838, foreign-owned U.S. real estate investments would generally be taxed much more severely than other foreign-owned U.S. investments.

Such a heavy tax on foreign-owned U.S. real estate would not only be a deterrent to potential foreign investors intending to use a Netherlands Antilles company, but it would also create a strong incentive for foreign investors owning U.S. real estate through Netherlands Antilles companies to liquidate their U.S. holdings.

What it would mean for the Netherlands Antilles would be a sudden termination of a significant profit center in the Antillean economy and probably the end of its international financial sector. Thus, by deleting the treaty override provision of the branch tax, not only will the Netherlands Antilles be helped, but the United States would achieve what we believe is a sound policy for taxing foreign-owned U.S. real estate investment.

The continuing deterioration of our economy may raise strategic issues for the United States. The Netherlands Antilles has often been of strategic importance to the United States. Notably, during World War II American troops and aircraft were stationed in the Netherlands Antilles; the troops to protect critical refineries on Aruba and Curacao and the aircraft to protect South Atlantic shipping against enemy submarines. Oil refined in the Netherlands Antilles fueled allied operations in Africa, Normandy and the Pacific during World War II and was again especially important to the United States during the Korean War and the 1973 oil embargo.

Finally, when it comes to fighting international crime, the Netherlands Antilles has traditionally been ready to work hand in hand with the United States. Our Government has testified on its long-standing cooperation with various agencies of the United States on tax and criminal investigations, particularly in the fight against drug trafficking. The extent of this cooperation has been acknowledged on various occasions by U.S. officials, including a commendation by the U.S. Attorney General in 1984 to the Attorney General of our country, Dr. Louis R. Nahr, in recognition of the unique contribution Netherlands Antilles law enforcement officials have made and continue to make in the prevention of illegal drug trafficking.

Our Government has offered to expand on its exchanges of information with the United States, both on civil and criminal matters. Among others, we have agreed to amend our bank secrecy laws in the context of a new treaty and to expand our legal possibilities for obtaining and providing information. It is our strong view, however, that in order for us to sustain the burden of these extensive undertakings, our offer on exchange of information must be part of an overall tax treaty package.

* * *

In 1984, even though the repeal of the U.S. tax on portfolio interest dealt a major blow to our economy, we felt gratified by the action of the U.S. Congress to save the Netherlands Antilles from immediate disaster. We also interpreted the action by the U.S. Congress and the dialogue at the meetings as a positive sign that there was a sensitivity in both Congress and the Executive Branch to the economic difficulties we are facing and to the impact of U.S. changes on our economy. By virtue of that sensitivity, we felt that an agreement on a new tax treaty was possible. To date, that has not been possible. However, we are confident that an agreement can still be reached with the active support of the U.S. Congress. Also, we are confident that the U.S. Congress will display the same sense of concern that it displayed in 1984 and that it will leave the issues of third party use of tax treaties to bilateral negotiations and not override our treaty in H.R. 3838.

N

NEXUS

Nexus Greenhouse Systems

10983 Leroy Drive Northglenn, Colorado 80233 303/457-9199

February 13, 1986

Attention: Betty Scott- Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Building
Washington, DC 20510

Dear Sir:

Tax Reform has become tax fiasco. Simplification has become complication. The House passed version of Tax Reform will deter growth and cost jobs. I urge the Senate to put aside Tax Reform and turn its attention to the more pressing matters of the Budget and Trade Deficits.

Sincerely,
NEXUS CORPORATION

Kirk McCrimmon
Administrator

cc: The Honorable William Armstrong
528 Senate Hart Office Building
Washington, DC 20510

The Honorable Gary Hart
237 Senate Russell Office Building
Washington, DC 20510

With Offices: P.O. Box 908, Zellwood, Florida 32798, (305) 886-1727 · Briarcliff 821, Spicewood, Texas 78669, (512) 264-2290

N

304 Opossum Road
Skillman, NJ 08558

February 13, 1986

Senate Finance Committee
U.S. Senate
Washington, D.C. 20510

Gentlemen:

I am very upset about the Tax Reform Act of 1985 (H.R. 3838), passed by the House of Representatives on 12/17/85 and now under consideration by the Senate. Since I am planning to retire in about 5 years, I am particularly interested in the effects of this bill on my pension.

My pension is with TIAA-CREF. It appears that this bill is directed principally against the pension funds of educational institutions held by TIAA-CREF, since virtually all other pension plans -- those of labor unions, business and industrial corproations, federal, state and local governments, and health and welfare organizations -- are not taxed. Furthermore, tax-exemption would be continued under the bill for pension funds held by most other exempt organizations, including fraternal organizations. This is grossly unfair!

If this bill is passed, the TIAA-CREF pension system's tax-exemption would be rescinded effective 1/1/88. The impact on my retirement benefits would be signficant. Over the years, at some sacrifice, I have put additional monies into the TIAA-CREF pension plan in order to be self-sufficient during my "retirement years." That last statement can also be read as "not dependent on government agencies for aid!"

Your help is needed to make changes in this bill to preserve the current tax treatment of my pernsion system and prevent my benefits from being reduced. I would appreciate your support on this matter.

Sincerely,

Camille Nini
Camille Nini

cc: Senator Bradley
Senator Lautenberg

N

NORTHEASTERN UNIVERSITY
360 HUNTINGTON AVENUE
BOSTON, MASSACHUSETTS 02115

OFFICE OF THE PRESIDENT

February 13, 1986

The Honorable Bob Packwood
Chairman
Committee on Finance
United States Senate
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Mr. Chairman:

As you know the House version of the tax reform bill (HR 3838) would revoke the tax exempt status of the Teachers Insurance Annuity Association and the College Retirement Equities Fund (TIAA-CREF). I wish to urge you, in the strongest possible terms, to reject this provision in whatever tax bill your committee sends to the Senate floor.

The House provision is palpably inequitable because it subjects to taxation only the college and university pension system while retaining exemptions for virtually all other pension systems. Because TIAA-CREF is organized and operated exclusively for employees of educational institutions, any taxation of the fund would ultimately reduce pension benefits to college workers, whose salaries are traditionally lower than other highly skilled professionals.

The Honorable Bob Packwood
February 13, 1986
Page 2

It has been suggested that TIAA-CREF could restructure their organization so as to escape payment of taxes on the pension portion of the operation. Such restructuring, would be extraordinarily difficult and would still add a significant cost to the pension system once again reducing benefits to retirees.

At a time when colleges and universities are bearing the brunt of other provisons in the tax reform effort--such as subjecting charitable gifts to the alternative minimum tax and greatly reducing access of colleges and universities to the tax exempt bond market--as well as suffering large reductions in federal student aid in the budget process, it is singularly inappropriate to burden individuals who have dedicated their lives to educating America's citizenry with what amounts to a direct tax on their retirement income.

Sincerely yours,

Kenneth G. Ryder
President

N

North
Jersey
Diamond
Wheel

218 Little Falls Road,
Cedar Grove, NJ 07009
(201) 239-5808

February 14, 1986

The Honorable Robert Packwood
Chairman
Senate Committee on Finance
219 Russell State Office Building
Washington, DC 20510
Attention: Ms. Betty Scott-Boom

Re: HR 3838, Tax Reform Act 1985

Dear Mr. Chairman:

We request that the following statement be included in the hearing record for HR 3838, the Tax Reform Act of 1985.

We feel that the tax reform bill proposed by the House Ways & Means Committee would have a series of adverse effects on the economy, particularly on capitol-intensive heavy industrial sectors (such as our industry), which in turn would have negative effects on both unemployment and the Gross National Product. It is also our opinion that the industrial sector would lose any competitiveness it had in the world market and be placed at a serious disadvantage by deleting the kinds of incentives that are available to industry in other countries. The United States would go from having one of the better capitol cost recovery systems to the single worst system of all industrial nations.

As a small manufacturer with heavy equipment costs, the current capitol cost recovery system with investment tax credits, are vital to the health of our business. Expansion and growth is linked to our ability to invest in very costly machinery and equipment. Adoption of the proposed tax reform bill would seriously jeopardize our ability to do business.

We strongly urge you, Mr. Chairman, not to lose sight of the fact that the health of today's economy is attributable to the expansion of industry which we feel is a direct result of the current capitol cost recovery system.

Let's work together to shape a tax bill which will foster U.S. industrial growth and competitiveness, one that is fair, simple, and economically sound, instead of a tax bill that once again shifts the tax burden on industry.

Sincerely,
NORTH JERSEY DIAMOND WHEEL

Bonnie A. Clark

Bonnie A. Clark
Treasurer

BAC:ap

cc: The Honorable William Bradley
The Honorable Frank Lautenberg
David W. Stoddard, NAM

N

Northwest Nazarene College
Nampa, Idaho 83651

OFFICE OF THE PRESIDENT

February 25, 1986

Members of the Senate Finance Committee
Committee on Finance
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Sirs:

This letter is to thank you for your efforts to continue to provide appropriate federal financial support for higher education and to appeal to you to continue the long standing tax exemption of TIAA-CREF.

As was stated clearly by James G. McDonald, Chairman and Chief Executive Officer, Teachers Insurance and Annuity Association and College Retirement Equities Fund, before the Senate Finance Committee in February 4, 1986, TIAA-CREF has come to play a vital role in the system of benefits for personnel in higher education.

You are aware of the growing stress on higher education with regard to funding. Northwest Nazarene College is a part of the private system of higher education and has been pleased to offer to our faculty the benefits of TIAA-CREF.

Senate Finance Committee
February 25, 1986
Page two

The faculty members and support personnel in private higher education commit themselves, on the whole, to financial sacrifice. The benefits that have been available through TIAA-CREF have helped in a positive way to ease that financial situation. To lose this tax exempt status would erode the value of this great benefit. This erosion will widen the gap between financial remuneration in the role of a teacher as compared to that available in much of commerce and industry.

I applaud the efforts of the US Congress to bring our nation to a more stable economy by reducing the national deficit. I call on you and your combined wisdom to find ways to achieve this end without diminishing this benefit to sacrificial servants of the American people.

Be assured of my prayers and my support.

Sincerely,

Gordon Wetmore
President

Representative Larry Craig
Senator James McClure
Representative Richard Stallings
Senator Steve Symms
Betty Scott-Boom (5) copies

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CABLE "OBERGMFG"
TELEX 81-2383

Oberg Manufacturing Co., INC
SILVERVILLE ROAD FREEPORT PENNSYLVANIA 16229-0315
(412) 295-2121

February 10, 1986

The Honorable Robert Packwood
Chairman
Senate Committee on Finance
219 Russell State Office Building
Washington, DC 20510

Attention: Ms. Betty Scott-Boom

As a representative of Oberg Manufacturing Company, "We feel nothing should be done to inhibit industrial growth, further lose the United States Competitive position, create greater unemployment, or increase the deficit.

Our Firm is very capital-intensive; therefore, we really discourage any loss of any current depreciation advantages.

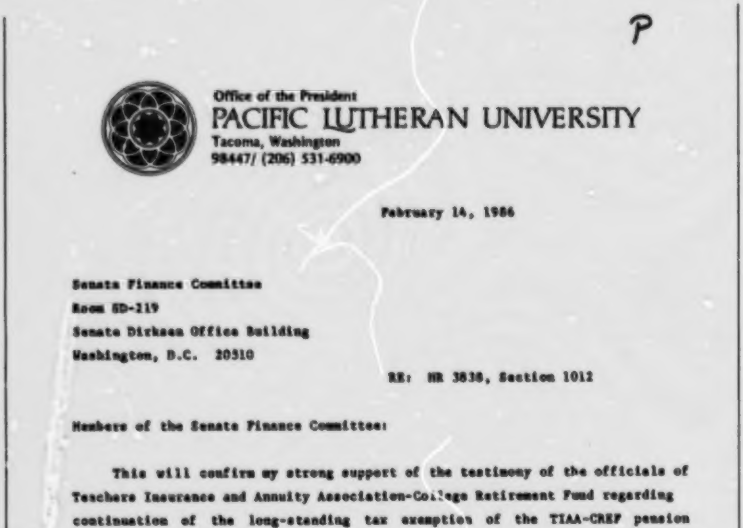
Please include my statement in the Hearing Record for HR 3838.

Thank you!

Sincerely,

A. G. Borland
Corporate Secretary

AGB:vb



P

Office of the President
PACIFIC LUTHERAN UNIVERSITY
Tacoma, Washington
98447/ (206) 531-6900

February 14, 1986

Senate Finance Committee
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

RE: HR 3838, Section 1012

Members of the Senate Finance Committee:

This will confirm my strong support of the testimony of the officials of Teachers Insurance and Annuity Association-College Retirement Fund regarding continuation of the long-standing tax exemption of the TIAA-CREF pension system.

The system was organized and operates exclusively for employees of non-profit educational institutions. By charter and trust law its assets support pension and related benefits for higher education, and cannot be diverted for any other purpose.

It is patently unfair to consider termination of tax-exempt status for TIAA-CREF, and yet continue such status for virtually all other pension funds. Such action would result in reduction of participant's pension benefits.

I urge continuation of tax exemption for pension funds held by TIAA-CREF.

Sincerely yours,
William O. Rieke
William O. Rieke, M.D.
President

aml

"Quality education in a Christian context"

P

PATTON, BOGGS & BLOW
2550 M STREET, N.W.
WASHINGTON, D.C. 20037
(202) 457-6000

H.R. 3838 -- U.S. Taxation of Shipping Income

This memorandum is submitted on behalf of Overseas Shipholding Group, Inc. ("OSG"), a U.S. corporation which, directly and through various subsidiaries and affiliates, is engaged exclusively in the ocean transportation of liquid and dry bulk cargoes in both the worldwide and self-contained U.S. markets. OSG currently owns and operates a fleet of 66 vessels, of which 14 are operated under the U.S. flag. A substantial majority of the remaining 52 vessels are owned and operated by so-called "controlled foreign corporations."

I.

Summary of Position

A. Subpart F Changes.

Under present law, foreign shipping income of a controlled foreign corporation ("CFC") is not treated as "subpart F income" when it is reinvested by the CFC in qualifying shipping assets. Section 621 of H.R. 3838 would repeal this provision of present law and thus subject certain of the U.S. shareholders of a CFC to immediate tax on the CFC's foreign shipping income whether or not such income is currently (or ever) distributed to those shareholders and whether or not such income is reinvested in qualifying shipping assets.

Present law should be retained. The sound policy reasons that prompted Congress to enact the reinvestment exception in 1975 are equally valid today. That exception recognized the competitive reality that the great majority of businesses in the international bulk shipping trades are not subject to taxation to any substantial degree. Thus, the reinvestment exception simply placed U.S. owners of CFCs on an equal footing with their vigorous worldwide competition. If the reinvestment exception is repealed as provided in H.R. 3838, U.S. corporations which engage in international shipping operations through foreign subsidiaries will be less able to compete in those markets and ultimately will be forced to curtail and eventually eliminate their foreign operations. In a competitive market, charter rates, particularly for long-term business, will tend to reflect closely the cost of capital and some rate of return for risk. In a non-tax environment, such as characterizes the international bulk shipping business, the imposition of an immediate income tax on the foreign shipping income of CFCs will place the U.S. firm at a competitive disadvantage, effectively raising the cost of capital to a prohibitive level. This would have adverse effects for the United States because of national security implications and declining stability of U.S. shipowners. The revenues to be collected by the government if the reinvestment exception is repealed are not substantial. The reinvestment exception to subpart F should therefore be retained so that CFCs, to the extent they reinvest their shipping income in qualified shipping assets, will continue to be subject to the general rules governing the taxation of foreign corporations and their shareholders.

B. Other Issues.

H.R. 3838 also modifies present law to expand the class of foreign corporations that will be treated as CFCs. For the reasons explained below, this change should either be rejected or reasonable transition rules should be provided. H.R. 3838 also modifies the merchant marine capital construction fund (CCF) provisions of existing law and incorporates those provisions (as so modified) into the Internal Revenue Code. For the reasons explained below, the proposed 10-year limitation on the accumulation of funds in a CCF should be deleted and the legislative history should clarify the binding effect for tax purposes of determinations by the Secretaries of Transportation and Commerce.

II.

Foreign Shipping Income Under Subpart F

A. Present Law

As a general rule, a foreign corporation is subject to U.S. tax only with respect to income it derives from U.S. sources or from a U.S. trade or business. Thus, a foreign corporation which conducts only foreign operations is not generally subject to U.S. tax. Additionally, the U.S. shareholders of a foreign corporation are generally subject to U.S. tax on the foreign corporation's income only when such income is distributed to them. An important exception to these fundamental principles of international taxation is contained in sections 951-964 of the Internal Revenue Code (the "Code"). Under these provisions, certain U.S. shareholders of a CFC are taxed currently on specified categories of the CFC's income ("subpart F income") whether or not such income is ever distributed to them.

When these provisions of the Code were originally enacted in 1962, foreign shipping income was not included in the definition of subpart F income. In the Tax Reduction Act of 1975, Congress included such income (as defined in section 954(f) of the Code) in the definition of subpart F income but only to the extent that the amount of such shipping income earned by a CFC in any taxable year exceeds the increase of the CFC's qualified investments in foreign base shipping company operations. See sections 954(b)(2), 954(g) and 955(b) of the Code. Income which has previously been deferred under the provisions described above must be taken into income by the U.S. shareholders of CFC in any subsequent taxable year in which the CFC reduces its qualified investments in foreign base shipping company operations. See sections 951(a)(1)(A)(iii) and 955(a) of the Code.

Thus, under present law, the shipping income of a CFC is not taxed currently to its U.S. shareholders (unless distributed to them) to the extent the CFC increases its qualified investment by a like amount. However, such deferral is recaptured if such income is actually distributed to the U.S. shareholders or the CFC decreases its qualified investment asset base.

B. H.R. 3838

H.R. 3838 would repeal the exclusion for reinvested foreign shipping income of a CFC, effective for taxable years beginning after December 31, 1985. Thus, foreign shipping income of a CFC would henceforth be currently taxable to the U.S. shareholders of a CFC as subpart F income whether or not such income is reinvested in shipping assets or repatriated to the U.S. shareholders.

C. Present Law Should Be Retained

The repeal of the subpart F shipping income reinvestment provision was not included in the President's tax reform proposals. The arguments advanced in the Ways and Means

Committee Report on H.R. 3838 are based principally on the theory that since Congress decided in 1975 that shipping income should be treated as subpart F income in some cases, it logically should always be so treated as matter of tax policy. See H. Rep. 99-426, 99th Cong., 1st Sess. 394-95 (1985).

The Ways and Means Committee's Report largely ignores the fact that in 1975 Congress also decided, for valid policy reasons, to continue deferral where such earnings are reinvested in qualified shipping assets. In 1975, Congress recognized the importance to the United States of the U.S. controlled fleet. The Treasury Department continues to recognize this fact. As it noted in another context in its explanation of the President's tax reform proposals in May 1985:

> "U.S. citizens own or control large numbers of ships registered in Panama, Liberia and Honduras that would be available to the United States in an emergency."

The validity of the Treasury's statement is underscored by the fact all of the Department of Defense contingency plans of which OSG is aware rely upon the use of the U.S. controlled foreign flag tanker fleet for the supply and resupply of petroleum to U.S. forces overseas. Moreover, the Treasury's recent options paper submitted to the Committee on Finance appears implicitly to recommend that the reinvestment exception be retained.

If H.R. 3838 is permitted to eliminate the reinvestment exclusion, U.S. owners of foreign flag ships will not be able to compete with owners in non-tax paying jurisdictions since the latter will be able to receive substantially lower charter rates than the U.S. owner to obtain the same return on investment thereby forcing the U.S. owner to lower its rates to unacceptable levels and ultimately to withdraw from this business. This would further result in U.S. owners being less diversified and therefore weaker in their remaining businesses which would be of additional detriment to the U.S. national interest. Further, a disincentive to new investment, as this change would be, is not consistent with Federal policies in other areas.

D. Proposed Transition Rules

If, despite the considerations outlined above, the reinvestment exception is repealed, transition rules are needed to prevent the harsh (and presumably unintended) results that would follow from enactment of H.R. 3838 in its present form. As explained above, under H.R. 3838, all post-1985 shipping income of a CFC would be treated as subpart F income and as such would be taxed currently to the U.S. shareholders of the CFC. Although H.R. 3838 thus appears at first blush to have only prospective application, this is not in fact the case. To illustrate, the shipping income of a CFC in 1986 and 1987 (and in subsequent years) will in large measure be derived from shipping assets acquired by the CFC through the reinvestment of its shipping income from prior years. When those investments were made, the CFC and its U.S. shareholders reasonably assumed that earnings on those investments would be eligible for deferral so long as they were reinvested. To now suddenly tax that income would be equivalent to changing the depreciation schedule for assets currently in service or taxing interest on State and local bonds that was exempt when the bonds were issued. In addition, as described below, taxes deferred in prior years will become due in an accelerated fashion as investments in shipping assets necessarily decline.

There is another equally critical problem that must be addressed by appropriate transition rules. As explained above, the tax deferral resulting from present law continues for all practical purposes so long as the CFC does not thereafter reduce its level of qualified investment in shipping assets. Thus, the U.S. shareholders of the CFC have not been required under generally accepted accounting principles for financial reporting purposes to reduce earnings and net worth to provide for these deferred taxes so long as it was expected that the CFC would continue its reinvestment policy.

Taking H.R. 3838 into account, and given the fact that many nations do not impose substantial tax burdens on international shipping ventures, it may be anticipated that H.R. 3838 will necessarily result in a diminished level of investment as the CFC both distributes a portion of its income to its U.S. shareholders to cover their new tax liabilities and becomes increasingly less able to compete in world markets. This will have a serious impact on two levels. First, the U.S. shareholders will likely be required to reduce their earnings and net worth (as reported for financial statement purposes) in the year H.R. 3838 is enacted to reflect what will then become the necessarily anticipated future taxation of previously deferred income. That the taxes on such previously deferred income will be paid over a period of years is irrelevant for financial reporting purposes. The magnitude of these one-time charges could be catastrophic (e.g., result in defaults under loan convenants). Second, as the level of a CFC's qualified investment in shipping assets actually decreases, the CFC will need to distribute funds to its U.S. shareholders to cover not only the previously unanticipated taxes on current income but the equally unanticipated taxes on previously deferred income. Absent further dispositions of shipping assets by the CFC, cash may not however be available to cover taxes on prior years' income since, to secure such deferral in the first place, substantially all such prior income would have been invested in non-liquid shipping assets. Thus, the elimination of the exclusion will become by its nature an incentive to liquidate these businesses and their related assets.

To counter the retroactivity inherent in the repeal provision two transition rules are needed. First, a transition rule should provide a time-limited exclusion for shipping income derived from current investments. "Current investments" should be defined to include investments in assets which were placed in service, produced under a binding contract entered into, or were under construction as of, the date final legislation is enacted. This exclusion should be in effect throughout the remaining original "useful life" of the asset (as determined for financial reporting purposes) from which income is derived in order fully to assure that investments already made will not become uneconomic solely because of a change in the tax laws.

This time-limited exclusion will also afford the shipping industry a transitional period in which to reorganize itself to attempt to continue operations profitably in the face of new and disproportionate levels of taxation by the United States. Excluding income derived from prior investments for the remaining useful lives of the underlying assets will facilitate the industry's need to reorganize without creating false incentives for future reinvestment.

Second, the only practical way to (i) eliminate the immediate "recapture" for financial reporting purposes of previously deferred income and (ii) the liquidation incentive necessitated by accelerated taxation as previously deferred income is taxed when qualified investment declines is to treat that income as previously taxed for subpart F purposes. This result could be accomplished by incorporating into H.R. 3838 a transition rule modeled on the rule which exempted accumulated DISC income from tax when DISC status was effectively revoked by changes in the law under the Tax Reform Act of 1984.

Prior law governing DISCs provided for a system of tax deferral not unlike the current subpart F provisions, as applicable to shipping income. Like CFC earnings, the profits of a DISC (usually a wholly-owned subsidiary of a U.S. corporation) were not taxed to the DISC but were taxed to its shareholders when distributed or deemed to be distributed to them. A substantial portion of DISC income was not taxed currently, and under prior law, would be subject to taxation only when actually distributed, or when the DISC was liquidated, distributed, exchanged or sold, or ceased to qualify as a DISC.

In order to compensate for the abrupt withdrawal of deferral privileges associated with DISC status, and the otherwise unavoidable impact on the financial statements of the affected corporations, Congress provided a transition rule (section 805(b) of the 1984 Act) which operated to forgive the tax on accumulated DISC income by treating such income as having been previously taxed. A second DISC transition rule provided that tax-free reorganization provisions, not otherwise applicable to foreign corporations, would apply to DISCs which opted to reorganize as FSCs (Foreign Sales Corporations).

Like DISCs, CFCs and their U.S. shareholders reasonably anticipated a continuing deferral of tax on their accumulated earnings so long as they followed the reinvestment policy prescribed by Congress in 1975. The proposed repeal of the reinvestment exception makes continued deferral impossible. Because of the imposition of tax on current shipping earnings, full reinvestment of earnings in shipping may no longer be possible and indeed may no longer be economically prudent in the face of competition from essentially non-taxable ventures. Unless accumulated earnings are treated as previously taxed, and the other recommended transition rule is adopted, U.S. shareholders will be placed in an untenable position from both a financial statement and tax payment point of view with respect to income earned and reinvested under existing law.

III.

Other Provisions of H.R. 3838

A. Definition of CFC.

Section 622 of H.R. 3838 would amend section 957 of the Code to modify the definition of a CFC in two respects.

Specifically, under H.R. 3838 it is intended that the subpart F rules will apply to the U.S. shareholders of a foreign corporation if 50 percent or more of either the voting power or value of the foreign corporation's stock is owned by certain U.S. persons. These changes from the "more than 50 percent of voting power" test of present law appear to have been patterned in part after the changes made by Congress to the consolidated return eligibility rules in the Tax Reform Act of 1984.

In OSG's view, while the addition of a value test may be appropriate, the shift to a "50 percent or greater" test is not necessary to prevent avoidance of the subpart F rules in cases where those rules should in fact apply. In any event, however, the effective date provisions of H.R. 3838 are wholly inadequate in two respects. First, when Congress faced a similar issue in 1984 with respect to the modification of the consolidated return eligibility rules, it provided a series of transition rules including a general three year delay in the effective date for affiliated groups which meet the eligibility tests of prior law. Congress should do no less here. Specifically, arrangements which qualified under present law on December 31, 1985 (i.e., met the more than 50 percent of voting power test) should not be subject to the new rules (50 percent or more of value or voting power) for taxable years beginning before January 1, 1989.

Second, a special transition rule should be provided with respect to assets owned by a foreign corporation on December 31, 1985 (or held by the corporation on that date pursuant to a binding contract) if the corporation would not have been treated as a CFC under present law. Under this rule, income produced by such assets would not be treated as subpart F income so long as the foreign corporation is not a CFC under the present law definition.

B. Capital Construction Funds.

Section 233 of H.R. 3838 makes substantial changes to the merchant marine capital construction fund (CCF) provisions of present law and incorporates those provisions into the Code for the first time. While the small amount of revenue to be raised ($20 million over five years) prompts OSG to question the need for any changes in present law, OSG is particularly concerned with two aspects of the CCF provisions embodied in H.R. 3838.

First, H.R. 3838 imposes a 10-year limit on the amount of time funds may be retained in a CCF without being withdrawn for a nonqualified purpose. Amounts which are not so withdrawn are treated as withdrawn in the form of nonqualified withdrawals ratably over the succeeding five taxable years. OSG can perceive of no policy basis for such a rule. For those who build smaller vessels, a 10 year period is probably adequate. At the same time, such a period will be too short for those who build larger more expensive vessels or who need to have a greater equity percentage in their vessels and thus need a longer accumulation period. An arbitrary time period is unnecessary as well as inappropriate. This is because the combination of the new tax treatment under H.R. 3838 of nonqualified withdrawals that would otherwise not be taxed under current law and the imposition of interest charges on all nonqualified withdrawals removes any meaningful financial incentive for unduly long accumulation periods. Moreover, the Secretary of Transportation (or the Secretary of Commerce in certain cases) must certify to the Secretary of the Treasury that the monies in a CCF are appropriate for vessel construction requirements. In these circumstances, there is neither a need nor a justification for an arbitrary time limit.

OSG is also concerned that the codification of the CCF provisions into the Code not be interpreted by the Internal Revenue Service in future years as a mandate to "second guess" certifications made by the Secretaries of Transportation and Commerce (who presumably will continue to use the standards of exisitng law). To prevent such problems from arising in the future, the Report of the Senate Finance Committee should confirm that the certification provisions are to be binding on the Secretary of the Treasury and the Internal Revenue Service. In this connection, we note that there is ample precedent for giving binding effect for tax purposes to determinations by other agencies. See sections 1071 (FCC), 1081 (SEC), and 1101 (Federal Reserve Board) of the Code.

Thomas H. Boggs, Jr.
Donald V. Moorehead

The
Impact of the Current Tax Reform Proposals on
Capital Recovery and Foreign Competition
in the Oilfield Manufacturing, Service and Supply Industries

Comments by the

Petroleum Equipment Suppliers Association

Submitted to the

Committee on Finance

U.S. Senate

February 14, 1986

Executive Summary

Already damaged by depressed market conditions that have lasted over four years, oilfield equipment manufacturers, service and supply companies and the customers they serve now face the prospect of major changes in the tax law that will inhibit capital recovery and put the industry at a further competitive disadvantage in the world market. In addition, the new proposed rules in HR 3838 will cause administrative duplication and contribute to further confusion and uncertainty in the industry.

The changes proposed in HR 3838 related to capital recovery would raise the cost of capital investment to PESA member customers by an estimated 11%.

With approximately one third of the industry's sales derived overseas, the foreign tax provisions of HR 3838 are particularly damaging. The foreign tax credit limitation, the deemed paid tax credit, the source of income and Subpart F limitations together with drastic changes in the licensing of technology abroad, research and development allocations to foreign earnings, and Section 911 changes constitute major new obstacles to U.S. companies as they try to compete in the world market.

A major reason for the complexity and unfairness of the present tax system is that the law is constantly being changed. The alternative minimum tax computation formula, changes in the depreciation, inventory accounting, foreign tax, and intangible drilling costs rules add significantly to the burden and uncertainty involved in administering an already complex system.

The Petroleum Equipment Suppliers Association opposes the present tax reform legislation because it transfers a large share of the tax burden to job-creating industry. It will make PESA members and their customers less competitive in world markets and contribute to increases in both the budget and trade deficits.

Background

In an effort to correct some of the unfairness in the Federal Tax Code, the Administration and the Congress are considering proposals that would seriously hurt the 239 member companies of the Petroleum Equipment Suppliers Association and their customers. Already damaged by depressed market conditions that have lasted over four years, oilfield equipment manufacturers, service and supply companies and the customers they serve now face the prospect of major changes in the tax law that will inhibit capital recovery and put the industry at a further disadvantage in the world market. In the House-approved version (H.R. 3838), these changes are compounded by new rules that will cause administrative duplications and further contribute to confusion and uncertainty in the industry.

The market has sent the oilfield equipment manufacturing/service/supply industry a clear signal that the demand for its products has contracted, and the industry is responding. In 1984, the last year for which data is available, industry sales were $33 billion and, excluding Schlumberger, a French company based in the Netherlands Antilles, the earnings of the industry were a negative $100 million. Roughly one third of the industry's sales, approximately $10 billion, were generated from overseas projects. In the process, the industry furnished employment to approximately 250,000 men and women in 46 states.

This is a far cry from the industry's 1981 numbers: $41 billion in sales, $6.2 billion in earnings, $16 billion in foreign sales and a workforce of 500,000.

During the period 1972-1982, the manufacturers of petroleum equipment invested more than $3.6 billion in new plant and equipment. Responding to the oil embargo and the increased demands of customers, the industry sustained a compound annual growth rate of 32.4 percent in capital investment in those ten years. This rate exceeded the 25 percent compound growth rate in sales for the same period.

No one will venture a guess as to when the continuing downward spiral of oil prices will end, but the havoc wrought on PESA member companies and their customers is the subject of regular news accounts. Since 1982, there have been nine acquisitions and 16 divestitures in an effort to avoid bankruptcies. The recent announcement that Global Marine, a major offshore driller, is seeking protection under Chapter 11, is the latest evidence of the increasing pressure on PESA customers and members.

As they struggle to survive in market conditions of depression proportion, PESA members and their customers are faced with the prospect of a new tax law that will further curtail the meager demand for oilfield equipment, place PESA members at an even greater competitive disadvantage in the world market and add layers of duplication and uncertainty in the administration of complex new tax laws for years to come.

If the problem were limited to the oilfield service industry alone it could be argued that the advantages of tax reform would be worth the sacrifice, but the oilfield service industry is not an isolated case. Almost every manufacturing and exporting industry has expressed the view that the proposals developed thus far are fundamentally inhibiting to U.S. participation in international trade. The proposals will also inhibit capital formation.

Capital Cost Recovery

Searching for oil and gas is an extremely complex, capital intensive business. A typical land-based drilling rig costs between $1 and $3 million. An offshore rig can cost more than $100 million.

Under the provisions of the Economic Recovery Act of 1981 (ERTA), the Accelerated Cost Recovery System (ACRS) allowed the recovery of eligible property using an accelerated method of depreciation over a predetermined recovery period that is generally shorter than the asset's useful life.

HR 3838 replaces the ACRS with a new system, the Incentive Depreciation System (IDS). The IDS deduction will be adjusted for inflation up to a limit of one half of the inflation rate in excess of 5%. The inflation adjustment is not considered a depreciation for purposes of determining the amount or character of gain (i.e., capital or ordinary). In addition, the 10% investment tax credit would be repealed.

These proposed changes related to capital recovery would have the effect of raising the cost of capital investment to PESA member customers by an estimated 11%. This increase would further decrease domestic oil and gas production while further increasing U.S. dependence on foreign oil and gas production. PESA customers and members cannot stand such an increase in view of the severe market conditions.

The proposals in HR 3838 regarding capital recovery are unwise at a time when the oilfield service industry and many other major industrial sectors face such severe economic strain. The oilfield manufacturing, service and supply industries and their customers as well as all capital intensive industry need the stability of the existing system that was put in place only in 1981.

Foreign Tax Provisions

With approximately one third of the industry's sales derived overseas, being competitive in the world market is no option -- it is an operational necessity. Yet the provisions in HR 3838 would add further obstacles to the host of non-tariff barriers PESA member companies and their customers must face. These provisions would drive U.S. companies out of foreign markets and leave the markets to foreign firms in countries with more favorable tax laws. There are eight areas of principal concern:

1. Foreign Tax Credit Limitation.

Under the present system, a company's foreign tax credit is limited to the U.S. tax that would be owed on a taxpayer's total net foreign source income world-wide. Recent tax laws have already substantially limited the availability of credits for foreign taxes, again in the name of tax reform. HR 3838 created additional "baskets" of income limitations including a basket for passive income such as dividends, interest and certain rents and royalties. Such income is usually considered as part of the total economic package when decisions are being made to invest in a foreign location.

To expand the categories of separate limitation income requires the foreign tax credit limitation to be calculated on a "per item" basis. To compound the complexity of the problem, HR 3838 requires that high taxed income be excluded for the passive income basket to prevent averaging high taxed income with low taxed income. This goes beyond the intent of applying a separate limitation on a specific category of income and requires that the limitations be applied to specific items within the passive income category.

The complicated and expensive to administer "look-through" provisions requiring companies to trace the income from foreign sources will unnecessarily burden foreign corporations increasing the inability of U.S. corporations to compete abroad. To trace the source and kind of income through several tiers of foreign corporations will be a nearly impossible task. This information must be secured from foreign corporations where accounts must be maintained according to local law. Language and currency translation problems are obvious. Equally formidable is the task of securing this information from foreign citizens and often from non-controlled foreign corporations whose other shareholders have no interest in bearing the expense of complying with U.S. tax rules for the U.S. shareholders. PESA urges that the present foreign tax credit limitation rules be retained and that the U.S. stop trying to defeat itself in the world market.

2. Deemed Paid Tax Credit

Under the provisions of HR 3838, dividends and Subpart F inclusions will be considered as disbursements from the pool of all the distributing corporation's accumulated earnings and profits. This provision has an adverse effect on PESA members' competitive position in the world market by increasing the cost of doing business abroad. PESA recommends that the current law be retained whereby distributions are considered to be made first out of the most recently accumulated profits of the distributing corporation.

HR 3838 repeals the rule whereby distributions made during the first 60 days of a taxable year are treated as paid out of the prior year's accumulated profits. PESA urges that this rule be retained in conjunction with retaining the current rules regarding the deemed paid tax credit.

3. Source of Income.

HR 3838 generally sources income to the residence of the seller. Requiring a fixed place of business abroad to avoid losing foreign source income will only increase the costs of doing business abroad. It will not create jobs for Americans, and the changes proposed for Sec. 911 will make it too expensive to add U.S. taxpayers to the payrolls abroad. The real beneficiary will be the foreign national employees and governments. If a fixed place of business is to be required, is there any rational reason why sales income created by such a location should be treated differently according to whether the purchaser is related or unrelated?

Even though a fixed place of business is located in a country, if its income is not taxed by the host country, such income cannot be foreign source income. No counterpart rule is proposed, however, to provide that expenses not deductable abroad should similarly not be considered foreign. PESA feels that the title passage rule in current law should be the controlling factor in determining the source of income.

4. Allocation and Apportionment of Expenses to Foreign Source Income.

HR 3838 requires members of an affiliated group to apportion all expenses to foreign source income as if the group were a single corporation. The resulting increase in the cost of doing business abroad far exceeds the perceived abuses in this area. As a result, PESA supports the retention of current law whereby expenses are apportioned between the U.S. and foreign source income on a separate company basis.

5. Subpart F Income.

The provisions of Subpart F in the tax code requires an immediate tax on certain types of income earned by controlled foreign corporations rather than when earnings are repatriated. Under current law, a controlled foreign corporation is one in which more than 50% of the voting power is owned by U.S. citizens that each own at least 10% of the voting power.

HR 3838 applies the 10% de minimis and 70% full inclusion rules for foreign based company income on the basis of earnings and profits. Again this provision will increase the cost of doing business abroad, and PESA recommends that the current law which applies these rules on the basis of gross income be retained.

For Subpart F rules to apply, HR 3838 amends U.S. ownership requirements. The bill states that for Subpart F rules to apply, 50% or more of the vote or value of a foreign corporation would have to be owned by 10% U.S. shareholders. Since the bill is concerned with defining U.S. control of a foreign corporation in terms other than solely voting power, PESA suggests that the bill be amended to require that more than 50% of the vote (current law) or value of a foreign corporation would have to be owned by 10% U.S. shareholders in order for the Subpart F rules to apply. In PESA's view, this will eliminate the perceived abuse of avoiding Subpart F income where the majority of the value of the Foreign corporation is actually held by U.S. shareholders without affectin the true 50-50 relationships that currently exist.

6. Sections 367 and 482

HR 3838 proposes a drastic change in the licensing of technology abroad. Present rules of long standing have required an arm's length standard which is applied when the license is entered into based upon the facts known at that time. The House provisions would require that license fees for the use of technology abroad be reset on a periodic basis, even if the payment schedule was set in the first instance on an arm's length standard. The

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Service may require an adjustment in the fee based upon the relevant facts and circumstances. From the statement in the Committee Report to the effect that any royalty should be "commensurate with the income attributable to the intangible," it appears that the Service could increase the royalties on any license which turned out to be successful. If the royalty which was set when the license was entered into was an arm's length royalty, the foreign government will not allow a deduction for the increased royalty required by the U.S. Revenue Service, and the result will be double taxation.

7. R&D Allocations under Regulations Sec. 1.861-8

Treasury Regulations Section 1.861-8 require apportionment of U.S. R&D expenses against foreign income. The effect of this provision would be to require the movement of R&D abroad since the only way to ensure full tax deductibility of R&D expenses is to perform the R&D in foreign countries. Recognizing this negative effect, Congress has previously adopted a moratorium on the effective date of these regulations. The moratorium has expired and HR 3838 has attempted a patch by allocating 50% of U.S. R&D to U.S. source income and the remainder between U.S. and foreign source based on relative sales of gross income for two years. A permanent extension of the moratorium, which more appropriately allocates 100% of U.S. R&D expenses to U.S. source income, would ensure that R&D would be conducted in the U.S. Not only would this keep the technology in the U.S., but it would also keep the related manufacturing and service jobs in the U.S.

The sum and substance of the foreign tax changes is to increase the cost of doing business abroad, thus making it even more difficult for PESA member companies to compete in the foreign marketplace. The result will be a loss of foreign income and a likely reduction in tax revenue from this source rather than a tax increase as projected.

8. Section 911

HR 3838 would reduce the maximum individual annual exclusion for foreign earned income of Americans working abroad from the present $80,000 to $75,000. Further, the bill would treat the excluded amount as a preference subject to the individual alternative minimum tax at 25%. The proposed revisions in Section 911 ignore the struggle which U.S. companies in the petroleum equipment manufacturing service and supply industries face in trying to maintain competent overseas staffs. It is an important item to the well being of the industry which generates over $10 billion in foreign exchange earnings each year-one third of its revenues. The need to maintain United States citizens in key posts in overseas operations is most important in order to properly manage this important revenue source. We recommend that the Section 911 provisions be retained. To change them will cause our industry to enter into new costly employment contracts.

Tax Administration

The chief reason for the complexity and unfairness of the present tax system is that the law is constantly being changed. In the past ten years there have been four major legislative and countless technical changes in the law. PESA believes that the American people would be better served if the system were allowed to function for a period without major changes. The present tax proposals contain numerous provisions that add to the level of administrative complexity without any evidence that the abuses they are intended to correct actually exist. Five of these provisions are particularly troublesome to PESA member companies and their customers.

1. Alternative Minimum Tax

As proposed, this provision would require the maintenance of a separate set of accounts solely to compute a minimum tax. If an alternative minimum tax is adopted, administrative rules outlining broad uniform concepts using existing accounting records should be developed. To include Foreign Sales Corporation (FSC) income in the calculation has the effect of directly undoing Congressional intent in 1984 in establishing FSC's. PESA members in foreign markets face competitors whose governments encourage exports through subsidies and tax incentives. To eliminate the FSC incentive at a time when the U.S. is faced with an enormous trade deficit is unbelievable.

2. Foreign Taxes

The treatment of foreign source income is already one of the most complicated provisions of the tax code to administer. The administrative problems would be compounded by the proposed changed providing for sourcing of income and expenses. The details of this are discussed under the Foreign Tax Credit Limitation section of this paper.

3. Depreciation

Most of the current proposals would create new classes of assets with complicated "place-in-service" rules which governs the amount of depreciation to be taken. The new treatment of assets, combined with indexing and multiple taxpayer classes, again require multiple bookkeeping, which could be very costly in relation to the minimum revenue gained.

4. Inventory Accounting

Present accounting systems would have to be overhauled to deal with proposals changing inventory absorption rules for manufacturing. They would also require dual accounting systems.

5. Intangible Drilling Costs

PESA member company customers who are independent oil and gas operators would be particularly hard-hit by this proposal. It strikes at a very heart of their ability to recover costs encountered in the search for oil and gas. In addition, it would require two accounting treatments for a single activity.

In summary, PESA opposes tax reform legislation in any of its present forms, because it transfers a large share of the tax burden to job-creating industry. The present proposals fail to encourage savings and capital formation while raising the cost of trading overseas. This will further erode the U.S. economy and increase both the budget and trade deficits.

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Program on Information Resources Policy

Anthony G. Oettinger
John C. LeGates
John F. McLaughlin
Benjamin M. Compaine
Oswald H. Ganley

To: Finance Committee
U.S. Senate
Washington, DC

cc: Speaker O'Neill
Senator Moynihan
Mr. MacDonald

From: Anthony G. Oettinger

February 18, 1986

I am writing to support the statement made to you by James G. MacDonald, Chairman and CEO of TIAA/CREF, at the hearings on H.R. 3838 of February 4, 1986 about the imposition of taxes that might reduce the value of my pension money held by TIAA/CREF.

I have stayed in academe for almost forty years now in spite of my still much greater market value in industry because I could alleviate the income gap, repay debts incurred to send my own kids to school, and expect not to beg in my old age because tax exemptions provided at least some relief from what otherwise would be intolerably low pay.

Whatever you may choose to do for future incentives for academic careers, it would be brazen robbery to break commitments made long ago to people who, like myself, are looking to retirement within a decade or so.

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P. Daniel Demko
Executive Director

Joseph T. Chadwick, Jr.
Associate Director

February 21, 1986

STATEMENT OF
THE PUBLIC EMPLOYER BENEFITS COUNCIL
BEFORE THE COMMITTEE ON FINANCE
UNITED STATES SENATE

HEARINGS ON H.R. 3838
January 29 and 30 and February 4, 5 and 6.

On December 17, 1985, the House of Representatives passed the Tax Reform Bill of 1985 (H.R. 3838) in an effort to raise revenue and reform the Internal Revenue Code (the "Code"). The bill contains a provision prohibiting all public employers (Federal, state and local governments) from maintaining cash or deferred arrangements under Section 401(k) of the Code ("Section 401(k) arrangements"). A limited grandfather provision was provided for certain existing plans which have already filed for a determination letter. Therefore, H.R. 3838 prevents public employers from adopting new Section 401(k) arrangements and prohibits some existing plans from continuing to be maintained. The bill also places a $7,000 annual contribution limit on Section 401(k) arrangements maintained by private sector employers. Private employers are, however, permitted to continue such arrangements.

The members of Public Employer Benefits Council (the "Council") have serious concerns regarding the unfair impact that the proposed elimination for public employers of Section 401(k) arrangements would have on them and their employees. The Council is an organization which includes members representing 24 State governments, along with a large number of city and county governments across the nation, whose total employees number over 1,000,000. One of the Council's primary objectives is to monitor and comment on proposed legislation that affects employee benefits provided by the public sector. The Council strongly opposes H.R. 3838 because it puts public employers and their employees at an unfair disadvantage vis a vis the private sector.

The Council filed testimony with the Senate Finance Committee on July 19, 1985 explaining that Section 401(k) arrangements are needed by public employers and that the benefits provided by such arrangements are not duplicative of other available benefits. Specifically, the testimony indicated that Section 401(k) arrangements provide benefits which are superior to those available through plans maintained under Code Section 457 because such arrangements are funded by trusts which are independent of the employer's general creditors and because employee access to benefits under such arrangements is less restricted than under Section 457 plans. In addition, Section 457 plans do not fit into an overall retirement benefit scheme as easily as do Section 401(k) arrangements. Finally, the testimony indicated that any perceived overlap between the two types of benefits should properly be taken care of by offsetting the extent of allowable contributions under Section 457 by contributions made to Section 401(k) arrangements and not by eliminating such arrangements.

The purpose of the present testimony is to consider the rationale used by the House in deciding to prohibit Section 401(k) arrangements for public employers, thereby singling out public employers for discriminatory treatment. The sole reason the House eliminated such arrangements for public employers was to raise revenue to pay for other tax benefits provided in the bill. This rationale is insufficient for two reasons. First, it is inappropriate from a policy standpoint to make public employees pay for tax benefits provided to others: discrimination for the sake of creating other tax advantages is unjustifiable. Second, the Council believes that the Joint Committee's revenue estimate used by the House grossly exaggerates the true cost of continuing Section 401(k) arrangements for public employers. Therefore, this unfair treatment will not provide the anticipated savings with which to fund other tax benefits. Discrimination against public employees is, of course, an unacceptable policy, but it becomes more egregious when it is based upon a greatly flawed estimate of revenue savings. It is especially crucial to have accurate revenue estimates when inequity is balanced against cost.

It is our understanding that, at the time the Ways and Means Committee was considering whether or not to allow public employers to continue to maintain Section 401(k) arrangements, the Joint Committee estimated the cost of continuing such arrangements to be $4.2 billion over the next five years, assuming a $12,000 annual contribution limit. H.R. 3838 as finally passed includes a $7,000 contribution limitation. Thus, on that ground alone the Joint Committee's figures significantly overestimate the actual savings in H.R. 3838.

We believe that apart from the difference in contribution limits the Joint Committe's revenue estimate is too high. The Joint Committee estimated the five year cost of continuing all Section 401(k) arrangements (as they currently exist) to be $15.9 billion. It is difficult to understand how the continuation of Section 401(k) arrangements for public employees only could cost $4.2 billion during the same time period when public employees constitute approximately 13 percent of the total work force, particularly since participation in such arrangements by public employees is currently significantly less than that by private sector employees.*

To calculate a useful estimate of the revenue impact of prohibiting public employers from continuing to maintain Section 401(k) arrangements, certain factors unique to public employers must be considered. First, the percentage of public employees currently eligible to participate in Section 401(k) arrangements is less than one-quarter of the percentage of eligible private employees. Because of this current low level of participation it will be many years before participation by public employees reaches the level of that by private employees. Thus, a useful estimate must consider a reasonable phase-in period over which public employees will "catch-up" with the participation level of private employees. Second, some public employers currently maintain Section 457 plans. Since, as indicated, Section 401(k) arrangements are more desirable than Section 457 plans, a certain level of contributions to public Section 401(k) arrangements will reflect merely a shift of contributions from Section 457 plans. Amounts deferred under either Section 457 or 401(k) are not currently taxable so it makes no difference from a revenue standpoint if an amount is contributed to a Section 401(k) arrangement or a Section 457 plan. Further, given the option, many public employers may prefer to adopt Section 401(k) arrangements in the future instead of Section 457 plans. Again, that will affect the revenue impact because at least some of the contributions going to the Section 401(k) arrangements would have gone to the Section 457 plans instead. So, it is necessary to discount estimates of additional revenue cost of continuing public Section 401(k) arrangements to take into account this mere shifting of contributions.

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* The Council believes that the Joint Committee's figure may include the cost of making Section 401(k) benefits available to all public employers -- Federal, state and local governments. Under current law the Federal Government cannot offer a Section 401(k) arrangement to its employees: A separate act of Congress is required to authorize a Federal Section 401(k) arrangement. Thus, prohibiting Federal employees in H.R. 3838 from being eligible for benefits under Section 401(k) has no revenue effect. The Council believes that Federal employees should not be considered in determining the revenue impact of H.R. 3838 and that any legislation which enables the Federal Government to provide Section 401(k) benefits should properly be charged with the cost of such a program. If the Joint Committee included Federal employees in its revenue estimate as the Council believes, the cost of continuing such benefits for non-Federal public employers is overstated. It should also be noted that the House and Senate have both considered bills which would provide Section 401(k)-type benefits to Federal employees. If either of these bills become law then only state and local governments will be prevented from maintaining Section 401(k) arrangements, thereby exacerbating the discrimination inherent in H.R. 3838.

Taking into account the "catch-up" described above and using a $7,000 annual contribution limit, the Council estimates the cost of allowing non-Federal public employers to continue to maintain Section 401(k) arrangements to be approximately $850 million over the next five years.* To arrive at this figure the Council used the five year cost of maintaining the status quo ($15.9 billion) and factored in the effect of the annual contribution limit, determining the cost of continuing Section 401(k) benefits for all employers with a $7,000 contribution limit to be $11.06 billion. This $11.06 billion total cost figure was then multiplied by the percentage (13.2%) that public (non-Federal) employees constitute of the total number of employees potentially eligible for coverage under Section 401(k) arrangements. A figure of $1.46 billion was reached, and this number was then scaled down to consider the low current availability of such arrangements to public employees and a phase-in of participation over time. Considering a "catch-up" in availability by the public sector by 1996, the Council determined the five year revenue cost of continuing to allow public (non-Federal) employers to maintain Section 401(k) arrangements to be less than $850 million. The following chart illustrates this methodology:

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* Because we have no real basis for measuring its effect, that estimate does not even take into account the shifting of contributions from Section 457 plans to Section 401(k) arrangements, which should reduce it even further.

Five Year Revenue Cost Of Allowing Public Employers to Contain To Maintain Section 401(k) Arrangements

			(in millions) (1986 - 1990)
1.	Revenue Savings From Complete Repeal of Section 401(k)		$15,900
2.	Revenue Savings Due To $7,000 Annual Cap		$ 4,840
3.	Cost of Continuing Section 401(k) Arrangements For All Employers (line 1 minus Line 2)		$11,060
4.	Public Employees as a Percentage of the Total Employees Potentially Eligible	13.2%	
5.	Cost of Section 401(k) Arrangements for Public Employers At Full Participation Levels (Line 3 x line 4)		$ 1,460
6.	Factor in 10 Year "Catch-up" of Public Sector Participation (Beginning at 5% increasing to current Private Sector Percentage (21.5%) over 10 years)		

1986	$43
1987	$120
1988	$156
1989	$224
1990	$303
TOTAL	$846

7.	Total Cost of Continuing to Maintain Section 401(k) Arrangements for Public Employers under H.R. 3838	$ 846

The Treasury Department recently issued a proposal to increase the annual Section 401(k) contribution limitation to $10,000, at a five year estimated revenue cost of $1.2 billion. The Council believes it is wrong to consider increasing the annual contribution limitation before eliminating discrimination against public employers. A $7,000 cap applied across the board to all employees (including public employees) is far more equitable and, in fact, less costly than increasing the benefits for one group of employees while eliminating benefits for another.

The $850 million figure more closely approximates the actual revenue impact of H.R. 3838 than does the Joint Committee's figure for the reasons outlined above. It is vital that correct cost figures be used when weighing equity against revenue impact. And, when the accurate revenue cost of continuing current benefits for public employers is considered, it is impossible to condone the unfair discrimination contained in H.R. 3838. Moreover, regardless of the cost, discriminating against public employees and denying them benefits available to the private sector (and potentially to Federal employees) is fundamentally unfair and cannot be justified.

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION ON S. 1959, THE SECONDARY MARKET TAX AMENDMENTS OF 1986, AND S. 1978, THE RECOVERY ACT FOR MORTGAGE AND OTHER ASSET-BACKED SECURITIES, BEFORE THE SENATE FINANCE COMMITTEE'S SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

Washington, D.C.
January 31, 1986

STATEMENT OF THE PUBLIC SECURITIES ASSOCIATION BEFORE THE SENATE SUBCOMMITTEE ON TAXATION AND DEBT MANAGEMENT

The Public Securities Association welcomes this opportunity to express its support for the objectives of Senate Bill 1959, also known as the "Secondary Market Tax Amendments of 1986" (SECTA) and, Senate Bill 1978, also known as the "Recovery Act for Mortgage and Other Asset-Backed Securities" (RAMBO). These proposals would remove many of the statutory and regulatory impediments which have prevented the issuance of multiple-class mortgage pass-through securities. These impediments have inadvertently had the effect of preventing mortgage-backed securities from becoming a more efficient means of financing residential housing. Moreover, these pieces of legislation will foster the creation of a well-balanced mortgage credit distribution system and will promote the linkage between the nation's capital markets and its mortgage credit markets, to the benefit of all homebuyers throughout the country.

PSA is the national trade association which represents the commercial banks and securities dealers which underwrite, trade and distribute mortgage-backed securities, U.S. government and federal agency securities and state and municipal securities. Included among our membership of approximately 300 firms are all the leading mortgage-backed securities dealers and all thirty-six primary government securities dealers as recognized by the Federal Reserve Bank of New York.

The residential secondary mortgage market is of rather recent origin. The first secondary mortgage market transaction between two savings and loan institutions took place in 1949. This market is the principal means by which thrift institutions and other mortgage originators are able to sell newly originated mortgages, or older mortgages held in portfolio, to raise capital to finance new mortgage loans. This has been accomplished through the sale of either whole mortgages or through the use of mortgage-backed securities. Mortgage-backed securities have provided the advantages of greater liquidity and diminished risk of loss than the purchase of individual whole mortgages.

Historically, the function of this market was to redistribute funds among various areas of the nation which might have been facing regional mismatches in the cost and availability of mortgage credit. For example, many slower growing areas of the country faced periods of time where there was a greater supply of mortgage credit available for lending than demand for it by local homebuyers. Conversely, many of the faster growing areas of the country frequently had greater demand for mortgage credit than dollars available to lend. The secondary mortgage market by purchasing mortgages in the faster areas of growth and selling them in the slower growth regions, redistributed available mortgage funds throughout the country. This system proved to be adequate for many years.

However, today, additional sources of investment in residential mortgages are necessary because nationwide demand for mortgage credit has increased more rapidly than the deposit bases of traditional mortgage lending institutions. The proposals being considered by the Committee today represent efficient vehicles for accomplishing this vitally important public policy objective. Through the years the Congress has taken a leadership role in developing the residential secondary mortgage market. The Government National Mortgage Association ("GNMA"), the Federal National Mortgage Association ("FNMA") and the Federal Home Loan Mortgage Corporation ("FHLMC") have each been and should continue to be important elements in this market's projected growth. Collectively, these federally created organizations have been responsible for issuing approximately $370 billion in mortgage backed securities.

It has been estimated that the total mortgage credit need for 1986 could exceed $230 billion. In order to efficiently provide this staggering volume of mortgage credit, we urge the Congress to begin to take steps to promote more efficient means of securitization and sale of mortgage-backed securities. (For purposes of this statement, securitization means the process by which large numbers of mortgages are pooled into mortgage-backed securities which are subsequently sold in fractionalized form as security interests in the pooled mortgages.) Over the next decade it has been estimated that $4 trillion dollars will be needed to finance housing in this country. The only way to satisfy this enormous demand for mortgage credit is to encourage additional access to our nation's capital markets from the private sector. This can best be accomplished through the creation of new mechanisms which allow mortgage issuers to more efficiently securitize mortgages. The adoption of legislation like SECTA and RAMBO would represent a significant positive step in this direction.

We anticipate many benefits from these legislative initiatives. In our opinion, the most significant of these benefits will be the removal of uncertainty with regard to the tax implications of establishing a multi-class pool of mortgage-backed securities. At the present time, pools of mortgage-backed securities are typically organized in the form of "grantor trusts." Unless organized in this fashion, pools of mortgage-backed securities would be subject to taxation at both the pool-level and at the investor level. Both, the RAMBO and SECTA proposals contain provisions making it clear that income from these multiple-class mortgage-backed securities would only be recognized at the investor level. The RAMBO proposal allows multiple classes of pass-through securities to fall within the amended provisions of the grantor trust rules, if these classes representing interests in the same pool of assets are issued simultaneously, and are not changed after issuance. The SECTA proposal accomplishes this by authorizing the creation of a new mortgage-backed security - the Collateralized Mortgage Security (CMS) which permits CMO-like investment arrangements to be structured as ownership interests in a passive multiple class entity.

In addition, clarifying the tax status of these instruments will result in reduced transaction costs and therefore result in greater market efficiency. Legal fees, along with other transaction costs, would be reduced because tax opinions would no longer be necessary. This would reduce costs that are ultimately borne by investors.

Both proposals would also allow for the sale of assets accounting treatment for tax purposes. By selling mortgages instead of issuing debt backed by mortgages, institutions would not be required to carry the added debt on their balance sheets. Since the transaction is not recorded as debt on the balance sheet it will greately benefit lenders without large amounts of capital. This should significantly enlarge the universe of potential lenders and create additional sources of funds for the mortgage market generally.

Both RAMBO and SECTA also contain two major provisions which would tend to expand the "investor base" in mortgage-backed securities. First, both proposals provide that the instruments created would qualify as "investments in mortgages" under the Tax Code thus enabling thrift institutions and real estate investment trusts to invest in these securities. Second, both pieces of legislation permit the creation of different or multiple classes of securities based on the maturity and cash flow preferences of different types of investors. For example, this would permit the creation of mortgage securities that provide thrift institutions with the short maturities they need to match against their short-term liabilities; life insurance companies with the medium-term maturities they require; and pension funds with the stable long-term maturities which they prefer.

Moreover, it is reasonable to anticipate that the increased marketability of these types of securities will result in more advantageous pricing. Greater competition among mortgage lenders at the origination level, as well as greater competition among mortgage-backed securities dealers to serve as market makers in these securities should lead to this result. As the secondary mortgage market becomes even more liquid and efficient we also expect to witness a narrowing in the yield spreads between mortgage-backed securities and Treasury securities. Lower mortgage interest rates at the origination level should result, significantly benefiting all of the nation's potential homebuyers.

For these reasons, we strongly support the objectives of the SECTA and RAMBO proposals and believe that Congressional consideration of this issue is perfectly appropriate within the context of the broader debate currently under way on the issue of comprehensive tax reform.

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TESTIMONY
OF
ALBERTO M. PARACCHINI, PRESIDENT
OF THE
PUERTO RICO BANKERS ASSOCIATION
BEFORE THE
SENATE FINANCE COMMITTEE
REGARDING THE
IMPACT OF THE TAX REFORM BILL OF 1985
ON THE FINANCIAL SYSTEM OF PUERTO RICO
FEBRUARY 6, 1986

Good morning - My name is Alberto M. Paracchini and I am Chairman, President and Chief Executive Officer of Banco de Ponce, a two billion dollar Puerto Rican commercial bank. I appear before you today in my capacity as President of the Puerto Rico Bankers Association which represents the Island's eighteen commercial banks. On behalf of the commercial banking industry of Puerto Rico, I should like to express our sincere appreciation for giving us the opportunity to alert this Committee regarding the adverse effects which certain provisions of "The Tax Reform Bill of 1985" (H.R. 3838) will produce on the financial system of our Island.

Section 936 and Puerto Rico's Financial System

I should like to begin by describing the importance of the Internal Revenue Code's Section 936 to Puerto Rico's financial system, and indeed, to our entire economy.

Section 936 of the Code, known as the Possession Tax Credit, is one of the principal economic underpinnings of Puerto Rico's economy. Enacted in 1976 as an amendment to an earlier tax sparing provision, it generally exempts from U.S. income taxes certain income of qualifying domestic corporations engaged in a trade or business within a possession ("936 corporations"). The provision also exempts the "qualified possession-source investment income" of such corporations. This provision also renders taxable the investment earnings of those 936 corporations which are derived from sources outside the possessions. As a result of the 1976 amendments and in order to derive tax free qualified possession-source investment income, 936 corporations operating in Puerto Rico began returning to the Island funds held overseas, primarily in the Eurodollar market. The influx of these so-called Section 936 funds alleviated the critical lack of resources being experienced by Puerto Rico's financial system at that time and provided a needed impetus for economic growth.

In addition, the Puerto Rican government has imposed a "tollgate tax" on repatriation of income earned by these 936 corporations; however, this tollgate tax is reduced in accordance with a formula which takes into account the length of time such income has been invested within the Island directly or indirectly through the Island's financial system. Thus, the longer the income is invested in Puerto Rico, the lower the tollgate tax that must be paid. Strict local rules govern the investments that can be made by banks and other financial intermediaries with Section 936 funds in order to qualify for the special tax treatment.

These Section 936 funds have grown over the years as 936 corporations have deposited accumulated operating earnings with Puerto Rico banks and thrift institutions. Section 936 funds currently on deposit with Puerto Rico's commercial banks amount to $6.8 billion, or 44% of the $15.4 billion in total commercial bank deposits. Section 936 funds on deposit with the Island's thrift institutions amount to $1.1 billion, or 40% of the average balance of total thrift institution deposits. The availability of this low cost pool of funds is vital to the economic growth of Puerto Rico.

Let me briefly explain what the banking industry has done with the available pool of Section 936 funds. In order to qualify for exemption from taxation by the U.S. and Puerto Rico, the 936 corporations must certify to the Puerto Rico Department of the Treasury (and to the U.S. Secretary of the Treasury under proposed amendments to federal Internal Revenue Code regulations) that the funds will be invested in "eligible" activities. The receiving depository institution must in turn certify to the Section 936 depositor (and to the Puerto Rico Department of the Treasury) that the funds will be invested in eligible activities. Compliance with these certifications is verified by independent auditors and by the Puerto Rican government.

Current Puerto Rico law and administrative regulations provide that eligible depository institutions must invest at least 20% of their daily monthly average of eligible Section 936 deposits in obligations of the Puerto Rican government, its agencies and municipalities. As of December 1985, over $2 billion had been invested in these obligations thereby substantially improving their marketability and reducing by approximately $32 million per year the interest cost on borrowings by the Island's government. These investments have greatly enhanced the support of Puerto Rico's $8.75 billion public debt, most of which is held by investors throughout the U.S. mainland.

An additional 10% of Section 936 deposits must be redeposited with the Government Development Bank for Puerto Rico. The additional funding has strengthened the financial position of that bank, which is Puerto Rico's Fiscal Agent, enabling it to obtain better terms for public sector financing, and to provide additional resources for small, promising private ventures that are otherwise unable to obtain credit from the Island's financial system. In order to stimulate the construction and housing industries, current regulations also require that an additional 7% of Section 936 deposits be invested in new construction or residential loans. The balance of Section 936 funds on deposit with Island depository institutions must be invested by banks in economically productive commercial, industrial, agricultural, or public purpose loans. It is important to note that all Section 936 funds must be invested within Puerto Rico in order to qualify for the tax advantages.

By reducing the cost of money to banks and thrift institutions on the Island, the large pool of Section 936 funds on deposit has enabled these institutions to benefit consumers and business by dramatically reducing lending rates. A recently-completed Puerto Rican government study of lending practices has determined that while borrowers were paying an average of 3.46% above the prime rate in 1975, by 1985 they were only paying an average of 59% below the prime rate, a difference of over 405 basis points. This differential represents a savings to borrowers of over $112 million per year.

Section 936 deposits are characterized by their short term nature. Approximately 70% of all such deposits bear maturities of 90 days or less; only 10% have maturities of one year or longer. The reason for the short term nature of these deposits is that corporate treasurers are very much risk adverse. Uncertainty over interest rates, corporate cash needs and future changes to Section 936 compel these corporations to keep these funds in relative liquid form so that they may be repatriated to the mainland or to anywhere else in the world with a minimum delay.

Amendments to Section 936 Proposed by HR 3838

H.R. 3838 includes amendments to Section 936 which would reduce Section 936 deposits with the Island's depository institutions. Given the vital importance of these funds to the economic well being of the Island, the Puerto Rico Bankers Association is particularly concerned lest those proposed amendments be enacted into law.

Subsection 641(d) of H.R. 3838 would increase from 65% to 75% the amount of income that must be received by a Section 936 corporation from the active conduct of a trade or business. Accordingly, the maximum amount of qualified possession-source investment income which may be received by a 936 corporation would be correspondingly reduced from 35% to 25% in order to qualify for the tax benefits. Because exceeding the 25% limitation would result in the immediate disqualification from Section 936 status, most 936 corporations will tend not to receive more than 20% of their income from qualified possession-source investments in order to avoid involuntary disqualification. We must bear in mind that Puerto Rico's financial system is just now beginning to absorb the reduction in the qualified possession-source investment income limitation enacted barely three years ago. That amendment reduced the limitation from 50% to 35% of total gross income. The further reduction to 25% proposed by H.R. 3838 would effectively reduce the amount of Section 936 funds to less than one half of the pre-1982 levels.

To comply with the lower amount of possession-source investment income, corporate treasurers will be forced to make significant withdrawals from the Island's depository institutions. The effect of such withdrawals could be severe as the pool of Section 936 funds deposited in Puerto Rico would be seriously reduced. In order to compensate for the loss of deposits, banks and thrift institutions would begin a costly competition to attract non-Section 936 funds. This intense competition would require financial institutions to offer much higher interest rates on their time deposits with a resulting increase in the cost of funds for all banks.

The higher cost of money will force banks and other lending institutions to charge much higher interest rates to their clients and consumers in general. Small business will be particularly affected, since over 90% of all loans made by local banks do not exceed $250,000. Higher borrowing costs would not be the only adverse effect of a substantial withdrawal of Section 936 funds; the reduced lending base would force bankers to substantially restrict lending practices thereby effectively shutting off small and medium size, non 936 corporations from access to affordable sources of credit. These restrictive lending practices would unavoidably lead to a further contraction of economic activity and to higher unemployment in the sector that employs the largest number of persons - small business.

Another casualty of a reduced Section 936 deposit base, would be the Island's housing and construction industries. Already reeling from current economic conditions, these industries would be further affected by the proposed changes. The Puerto Rican government has established a Mortgage Trust in order to channel Section 936 funds into the housing market. More that $200 million in notes already have been issued to 936 corporations, the proceeds of which are being used to finance over 20,000 new, low cost homes. You can be sure that this and other similar worthwhile government initiatives will cease as corporate treasurers withdraw their deposits from the Island's banking system.

Subsection 641(b) of H.R. 3838 would repeal the longstanding requirement of Subsection 936(b) that in order to be exempt from U.S. taxes, income received by a 936 corporation must be received within the possession. Repeal of Subsection 936(b) would drain approximately $300-$400 million of Section 936 deposits from Island banks and thrift institutions, because 936 corporations would be permitted to receive the proceeds of their sales outside of Puerto Rico. Local banks use the float earned from Section 936 funds to blend down the interest rates charged to borrowers and as compensation for services performed on behalf of 936 corporations, such as delivering payrolls to remote plant locations. Repeal of Subsection 936(b) would also make more difficult the audit of Section 936 funds by Puerto Rico government auditors. The Secretary of the Treasury of Puerto Rico has expressed to me his concern over the proposed repeal of Section 936(b).

Conclusion and Recommendations

As we have seen, the further reduction in the percentage of qualified possession-source investment income and the repeal of the current rule requiring 936 corporations to receive in Puerto Rico the proceeds of their sales, represent a potential erosion to the liquidity and lending capability of the Island's banking system. The resulting withdrawals will trigger a new spiral in the cost of money thereby threatening smaller and weaker commercial banks and thrift institutions. There can be no policy justification for this result, particularly when the alleged revenue savings by the U.S. Treasury as a result of these changes amounts to only $50 million per year.

To avoid the above-mentioned ill effects of H.R. 3838's current provisions, the Puerto Rico Bankers Association would like to offer two recommendations to this Committee. First, we would recommend that the level of qualified possession-source income be retained at its current level of thirty-five percent. In the alternative, we would suggest that if a lower level is adopted, that the new amount be computed on the basis of a three-year moving average in the same manner in which the amount under Section 936(a)(2)(A) is currently computed. This would allow 936 companies the opportunity to avoid involuntary disqualification without having to reduce the level of qualified possession source investment income much below the 25 percent level.

Second, we are concerned that the repeal of Subsection 936(b) would diminish deposits in Puerto Rico's banking system by between $300 and $400 million and hamper auditing examinations by government auditors. The Puerto Rico Bankers Association, on behalf of the Island's eighteen commercial banks, recommends that Congress retain the current provisions of Subsection 936(b). If the Committee believes that a change must be made in Section 936(b), we recommend that such change be limited to allowing 936 companies to receive outside of the possession only any proceeds derived from sales to unrelated third parties; all other income of 936 companies must be received within a possession in order to qualify for the possession tax credit. This suggested compromise will address the problem of unrelated third party customers unknowingly depositing the proceeds of 936 company sales in accounts outside the possessions thereby destroying the eligibility of such funds for a possession tax credit. Because sales between related parties do not present a problem, we believe the proceeds of such sales should continue to be received within the possessions.

I should like to close by again thanking your Committee for the opportunity to voice our concerns regarding H.R. 3838's impact on Puerto Rico's commercial banking industry. Too many times because of Puerto Rico's unique legal status, legislative changes by the Congress produce unintended adverse effects on the Island. We welcome opportunities such as this to apprise our Nation's lawmakers of our particular situation.

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TESTIMONY
OF
MARIANO J. MIER
PRESIDENT,
FIRST FEDERAL SAVINGS BANK
OF SAN JUAN, PUERTO RICO
ON BEHALF OF
THE PUERTO RICO LEAGUE OF SAVINGS INSTITUTIONS
BEFORE THE
SENATE FINANCE COMMITTEE
REGARDING THE
IMPACT OF THE TAX REFORM BILL OF 1985
ON THE FINANCIAL SYSTEM OF PUERTO RICO
FEBRUARY 6, 1986

My name is Mariano J. Mier and I am President and Chief Executive Officer of First Federal Savings Bank, Puerto Rico's oldest and largest thrift institution.

I am very pleased to appear before you today on behalf of the Puerto Rico League of Savings Institutions. The League has as its members the Island's twelve federally-chartered thrift institutions whose combined resources amount to $4.8 billion, or twenty percent of the total resources of all depository institutions in Puerto Rico. On behalf of the League, I would like to thank you for the opportunity to express before your Committee the utmost concern of our membership regarding the adverse effects of certain provisions of the "Tax Reform Bill of 1985" (H.R. 3838), on the financial system of Puerto Rico.

The Importance of Section 936 to Puerto Rico's Financial System

First, let me explain the importance of the Internal Revenue Code's Section 936 to Puerto Rico's financial system, its vulnerable thrift industry and our entire economy at large.

Section 936 of the Code is known as the Possession Tax Credit and is one of the principal economic underpinnings of Puerto Rico's economy. Congress enacted Section 936 in 1976 as an amendment to an earlier tax sparing provision. Section 936 provides a full credit against U.S. income taxes for certain income of qualifying domestic corporations engaged in a trade or business within a possession ("936 corporations"). The provision also exempts the "qualified possession-source investment income" of such corporations. This provision also renders taxable the investment earnings of those 936 corporations which are derived from sources outside the possessions. As a result of the 1976 amendments and to derive tax free qualified possession-source investment income, 936 corporations operating in Puerto Rico began returning to the Island funds held overseas, primarily in the Eurodollar market. The return of these so-called Section 936 funds alleviated the critical lack of resources being experienced by our financial system at that time and provided a strong developmental incentive.

Additionally, the Puerto Rican government has imposed a "tollgate tax" on repatriation of income earned by these 936 corporations; however, this tollgate tax is reduced in accordance with a formula which takes into account how long such income has been invested within the Island directly or indirectly through the Island's financial system. Thus, the longer the income is invested in Puerto Rico, the lower the tollgate tax that must be paid. There are explicit local rules which govern the investments that banks and other financial intermediaries can make with Section 936 funds to be eligible for the special tax treatment.

These Section 936 funds have increased over the years as 936 corporations have deposited accumulated operating earnings with Puerto Rico banks and thrift institutions. Section 936 funds currently on deposit with Puerto Rico's commercial banks amount to $6.8 billion, or 44% of the $15.4 billion in total commercial bank deposits. Section 936 funds on deposit with the Island's thrift institutions represent 40% of the average balance of total thrift institution deposits, about $1.1 billion. These funds are vital to the banks' ability to finance new economic growth on the Island.

I will briefly describe what the banking and thrift industry have done with the available pool of Section 936 funds. In order to qualify for exemption from taxation by the U.S. and Puerto Rico, the 936 corporations must certify to the Puerto Rico Department of the Treasury (and to the U.S. Secretary of the Treasury under proposed amendments to federal Internal Revenue Code regulations) that they will invest the funds in "eligible" activities. The receiving depository institution must in turn certify to the Section 936 depositor (and to the Puerto Rico Department of the Treasury) that the funds will be invested in eligible activities. Compliance with these certifications is verified by independent auditors and by the Puerto Rican government.

Current Puerto Rico law and administrative regulations provide that eligible depository institutions must invest at least 20% of their daily monthly average of eligible Section 936 deposits in obligations of the Puerto Rican government, its agencies and municipalities. As of December 1985, over $2 billion had been invested in these obligations; such investment has improved their marketability substantially and reduced by approximately $32 million per year the interest cost on borrowings by the Island's government. These investments also have greatly enhanced the support of Puerto Rico's $8.75 billion public debt, most of which is held by investors throughout the U.S. mainland.

Under current Puerto Rican Treasury regulations, an additional 10% of Section 936 deposits must be redeposited with the Government Development Bank for Puerto Rico. The additional funding has enabled the Bank to increase its earnings. The strengthened financial position of the Bank, which is Puerto Rico's Fiscal Agent, has enabled it to obtain better terms for public sector financing, and to provide additional resources for small, promising private ventures that otherwise could not obtain credit from the Island's financial system. In order to stimulate the construction and housing industries, current regulations also require that an additional 7% of Section 936 deposits be invested in new construction or residential loans. The balance of Section 936 funds on deposit with Island depository institutions must be invested by banks in economically productive commercial, industrial, agricultural, or public purpose loans. Notably, all Section 936 funds must be invested within Puerto Rico in order to qualify for the tax advantages.

These Section 936 funds also benefit consumers and businesses. By reducing the cost of money to banks and thrift institutions on the Island, the large pool of Section 936 funds on deposit has enabled these institutions to dramatically reduce lending rates to consumers and businesses. A recently-completed Puerto Rican government study of lending practices has determined that while borrowers were paying an average of 3.46% above the prime rate in 1975, by 1985 they were only paying an average of 59% below the prime rate, a difference of over 405 basis points. This differential represents a savings to borrowers of over $112 million per year.

Section 936 deposits typically are of a short term nature. Approximately 70% of all such deposits bear maturities of 90 days or less; only 10% have maturities of one year or longer. The reason for the short term nature of these deposits is that corporate treasurers are very much risk adverse. Uncertainty over interest rates, corporate cash needs and future changes to Section 936 compel these corporations to keep these funds in relative liquid form so that they may be repatriated to the mainland or elsewhere without much delay.

Amendments to Section 936 Proposed by H.R. 3838

H.R. 3838 includes amendments to Section 936 which would reduce Section 936 deposits with the Island's depository institutions. As I have described, these funds are extremely important to the economic well being and development of the Island, and on behalf of the Puerto Rico League of Savings Institutions I wish to express our concern should those proposed amendments be enacted.

Subsection 641(d) of H.R. 3838 would increase from 65% to 75% the amount of income that must be received by a Section 936 corporation from the active conduct of a trade or business. Accordingly, the maximum amount of qualified possession-source investment income which may be received by a 936 corporation would be correspondingly reduced from 35% to 25% in order to qualify for the tax benefits. 936 corporations wishing to avoid involuntary and immediate disqualification from 936 status by exceeding the 25% limit will tend not to receive more than 20% of their income from qualified possession-source investments. We must bear in mind that Puerto Rico's financial system is just now beginning to absorb the reduction from 50% to 35% of total gross income in the qualified possession-source investment income limitation enacted barely three years ago. A further reduction to 25% as proposed by H.R. 3838 would effectively reduce the amount of Section 936 funds to less than one half of the pre-1982 levels.

To comply with the lower amount of possession-source investment income, corporate treasurers will be forced to withdraw significant amounts from the Island's depository institutions. The effect of such withdrawals throughout Puerto Rico's financial system could be severe as the pool of Section 936 funds deposited in Puerto Rico would be seriously reduced. In order to compensate for the loss of deposits, banks and thrift institutions would begin a costly competition to attract non-Section 936 funds. This intense competition would require financial institutions to offer much higher interest rates on their time deposits with a resulting increase in the cost of funds for all banks. Because of the structural imbalance in the maturities of their assets and liabilities, thrift institutions would not be readily able to compete for higher priced deposits. The potential migration of thrift deposits to higher paying commercial banks would severely strain the already financially vulnerable thrift institutions, all of which are federally insured.

The higher cost of money would harm consumers as well. It will force thrifts and other lending institutions to charge much higher interest rates to their clients and consumers in general. Moreover, small business will be particularly affected, since over 90% of all loans made by local banks do not exceed $250,000. Higher borrowing costs would not be the only adverse effect of a substantial withdrawal of Section 936 funds; in addition, the reduced lending base would force bankers to substantially restrict lending practices thereby effectively shutting off small and medium size, non 936 corporations from access to affordable credit sources. These restrictive lending practices would undoubtedly further contract economic activity and increase unemployment in the sector that employs the largest number of persons - small business.

A reduced Section 936 deposit base also would adversely affect the Island's housing and construction industries, which are already reeling from current economic conditions. The Puerto Rican government has established a Mortgage Trust to channel Section 936 funds into the housing market. More that $200 million in notes already have been issued to 936 corporations, the proceeds of which are being used to finance over 20,000 new, low cost homes. With the withdrawal of deposits from the Island's banking system, this and other similar worthwhile government initiatives certainly will cease.

I should like to emphasize the importance of access to the Section 936 capital market to Puerto Rico's thrift institutions. Though the Puerto Rican thrift industry accounts for only twenty percent of the total resources of all depository institutions on the Island, it is the source of fifty percent of all housing mortgages. Lower cost Section 936 funds have enabled thrifts to pass these savings on to Puerto Rican homeowners and to provide them with the opportunity to acquire adequate housing at more affordable interest rates. These homeowners, whose per capita income is only one half that of the lowest State of the Union, must bear a cost of living that is between ten and fifteen percent higher than that on the mainland. By stimulating the housing industry, thrift institutions have also been instrumental in keeping alive the Island's once-thriving construction industry, which is source of employment for a significant portion of our population.

As was the case with thrifts throughout our Nation during the late 1970's and early 1980's, thrifts in Puerto Rico were severely affected by the high interest rate environment and the effects of deregulation. Thrifts in Puerto Rico began to experience severe losses. Fortunately, a portion of the large pool of low-cost Section 936 funds found its way to the Island's thrifts by means of repurchase agreements. By March of 1985, approximately $1.1 billion of low cost Section 936 funds had been made available through this mechanism.

In addition to receiving these funds through repurchase agreements, thrifts were able to issue longer term debt obligations secured by the Federal Home Loan Bank of New York or the Federal Savings and Loan Insurance Corporation directly to Section 936 corporations at very favorable interest rates. Since 1982, more than $700 million of lower cost, longer term financing has been provided to Puerto Rico's thrift institutions directly by Section 936 corporations. A new program of the Federal Home Loan Bank of New York guarantees deposits made by Section 936 corporations in Puerto Rican thrift institutions. More than $125 million has now been deposited under this program with terms of up to three years.

The effect of this lower cost source on funds on the operations of Puerto Rico thrifts has been remarkable. Unlike the mainland, Puerto Rico has experienced no failures among its thrift institutions, although three institutions have been acquired by healthier associations. The 1.5% to 2% differential between the cost of Section 936 funds and the average cost of funds from other traditional sources represents an additional $18 to $22 million dollars for our industry. In 1984 this differential represented the difference between a net combined profit of $16.3 million and a $5.1 million loss.

Amendments to Section 861 Source of Income Rules Proposed by H.R. 3838

H.R. 3838 would make significant changes in the source of income rules of Section 861. Changes in these source of income rules would create problems for federally chartered thrift institutions in Puerto Rico which sell term notes, debentures or other capital notes to 936 corporations.

Under current law, interest paid by a federally-chartered financial institution operating primarily in Puerto Rico on its deposits is treated as income from sources without the United States under Section 861(a)(1)(F) of the Internal Revenue Code. Section 861(a)(1)(B) provides that interest paid by such an institution on its notes and debentures (non-deposits) is also treated as foreign source income to the recipient provided less than 20 percent of the financial institution's gross income (over a three-year period) is from sources within the U.S. Changes in the source of income rules under H.R. 3838 would create problems for federally-chartered financial institutions in Puerto Rico which attempt to induce 936 corporations to purchase their debentures, term notes or other debt securities.

To qualify for the tax benefits of Section 936, an electing corporation must receive at least 80 percent (over a three-year period) of its gross income from sources within a possession such as Puerto Rico. In addition, U.S. source income does not qualify for the 936 credit and is thus subject to U.S. tax. For both of these reasons it is important to 936 corporations that their passive investment income, which currently may constitute up to 35 percent of their gross income without disqualifying them from 936 status, be Puerto Rican source.

For purposes of determining Puerto Rican source income, section 1.863-6 of the Regulations provides that the principles of Sections 861 through 863 of the Code and Regulations are generally to be applied, with substitution of "Puerto Rico" for

"United States" wherever it appears in those provisions and treatment of a corporation organized in Puerto Rico as "domestic." However, in the case of any item of income, the income from Puerto Rican sources, for example, shall not exceed the income which is treated as income from sources outside the U.S. under normal application of the source rules. Regs. § 1.863-6. Thus, in order for income to qualify as Puerto Rican source for purposes of Section 936, it generally must first qualify as foreign source income under the normal source rules.

As described, under current law, interest paid by a U.S. corporation with less than 20 percent U.S. source gross income is treated as foreign source income. Subsection 612(a)(1) of H.R. 3838 would amend this provision so that such interest paid by a domestic corporation would generally be treated as U.S. source. Since all federally chartered thrift institutions in Puerto Rico are considered U.S. domestic corporations, the proposed changes would cause the interest paid to 936 corporations on debt securities issued by such institutions to be treated as U.S. source income.

The amendment to Subsection 861(a)(1)(B) would have an additional, and no doubt unintended, negative effect on the ability of federally chartered thrift institutions in Puerto Rico to attract non-deposit investments from 936 corporations. As described, under H.R. 3838, the source of interest on notes or debentures of such institutions would change from foreign to U.S., thus making the interest subject to U.S. tax in the hands of a 936 corporation and making it more difficult for the 936 corporation to maintain the 80 percent Puerto Rico source income necessary to receive the benefits of Section 936. The federally chartered financial institutions in Puerto Rico, like the rest of the financially troubled thrift industry, have needed substantial infusions of long-term, non-withdrawable debt capital. For such institutions in Puerto Rico, this need has been filled by investments from possessions corporations. However, the change in source rule under H.R. 3838 would make such investments extremely unattractive for 936 companies, and the resulting unavailability of this pool of capital could have seriously harmful effects on federally-chartered financial institutions in Puerto Rico. No new section 936 financings may be possible for thrift associations, which would be forced to replace these funds with higher priced deposits or loan advances from the Federal Home Loan Bank. Higher cost of money would result in a lower or perhaps even a negative spread by these thrifts with the concomitant pressure on the Federal Savings and Loan Insurance Corporation.

The same provision of H.R. 3838 would have a similar effect on individuals who are bona fide residents of Puerto Rico. Under Section 933 of the Code, such individuals are exempt from

U.S. tax on income derived from sources within Puerto Rico. Although interest on non-deposit investments paid by a federally chartered financial institution in Puerto Rico to such individuals is currently treated as Puerto Rican source under the provisions described above, H.R. 3838 would convert such interest to U.S. source income not qualifying for exemption from U.S. tax under Section 933. (The exemption of Section 897(i) contained in H.R. 3838 would not be applicable either; Puerto Rico citizens are not treated as nonresident aliens under Section 932. Regs § 1.932-1(b).) This result, like that for interest paid to possessions corporations, is no doubt unintended.

The Puerto Rico League of Savings Institutions believes that the effects described above are wholly unintended. We respectfully recommend that this problem be addressed by adding the following provision to the new section 861(a)(1)(D) proposed by H.R. 3838:

> "(ii) on deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loans or similar associations under Federal or State law, or on debt securities issued by such institutions, but only to the extent that amounts paid or credited on such deposits, or accounts are deductible under Section 591 (determined without regard to Section 265) in computing the taxable income of such institutions."

Other Required Technical Amendments

Section 861(a)(1)(F)(i) currently provides that interest on deposits with a foreign branch of a domestic entity which is engaged in the commercial banking business or which is described in Section 861(c)(2) is treated as income from sources without the U.S. Section 861(c)(2) refers to deposits or withdrawable accounts with savings institutions chartered and supervised as savings and loan or similar associations under Federal or State law, but only if amounts paid on those deposits are deductible under Section 591.

Section 612(b)(4) of H.R. 3838 would retain the foreign branch deposit rule of section 861(a)(1)(F) but would change its designation from subparagraph (F) to subparagraph (D). However, that same provision of the Bill would strike out subsection (c), leaving a reference in new section 861(a)(1)(D) to a definition which would not exist. A definition for savings and loan and similar institutions is necessary, either through retention of that portion of section 861(c) with a cross-reference from section 861(a)(1)(D), or through inclusion of the definition in section 861(a)(1)(D), as was recommended hereinabove.

Conclusion and Additional Recommendations

In sum, H.R. 3838 threatens to erode the liquidity and lending capability of the Island's banking system by further reducing the percentage of qualified possession-source investment income and repealing the current rule requiring 936 corporations to receive in Puerto Rico the proceeds of their sales. The resulting withdrawals will trigger a new spiral in the cost of money and will endanger smaller and weaker commercial banks and thrift institutions. We cannot condone this result, especially when the alleged revenue savings by the U.S. Treasury as a result of these changes amounts to only $50 million per year.

The change in the source rules would produce the unintended result of denying access by the federally chartered thrift institutions to the Section 936 capital market. The higher cost of funds threatens the survival of weaker thrift institutions to the detriment of the federal insurance agencies.

The Puerto Rico League of Savings Institutions would recommend that the current level of qualified possession-source income be retained at thirty-five percent. Should Congress decide to adopt the lower level proposed by H.R. 3838, we recommend that it be computed on the basis of a three-year moving average in the same manner in which the amount under Section 936(a)(2)(A) is currently computed.

In closing, I would like to again thank your Committee for the opportunity to express our concerns regarding H.R. 3838's impact on Puerto Rico's financial system and thrift banking industry. Section 936 has been and continues to be the most effective and successful economic development incentive which the Congress has granted Puerto Rico. The proposed changes to Section 936 could adversely affect Puerto Rico's thrift industry, and most importantly, the 3.2 million U.S. citizens of Puerto Rico. Thank you.

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STATEMENT OF
THE PUERTO RICO MANUFACTURERS ASSOCIATION
BEFORE THE
SENATE COMMITTEE ON FINANCE
REGARDING
THE IMPACT OF H.R. 3838
ON THE ECONOMY OF PUERTO RICO

February 7, 1986

Mr. Chairman and honorable members of this Finance Committee, my name is Manuel Borrero and I am the President of the Puerto Rico Manufacturers Association, an organization comprised of more than 1,300 members representing the manufacturing, commerce and service sectors of the Commonwealth of Puerto Rico.

On behalf of the Association I thank you for the opportunity to express our views on the proposed tax reform legislation, more particularly, the area pertaining to Section 936 of the Internal Revenue Code.

Our Association fully appreciates that it is critical for the Nation to reduce its budgetary deficit. We also recognize the need for tax fairness and simplification as the basis of a strong and effective self-assessed taxing system. While supporting these goals, however, the Association is compelled to express its serious concern over the possibility that, as part of the proposed tax reform legislation, amendments are introduced that would impact Code Section 936 and have the unintended result of severely jeopardizing Puerto Rico's economic development program.

Section 936 - The most important tool in Puerto Rico's economic development program

In 1948, Puerto Rico embarked on an industrial development program which eventually produced a level of economic growth and prosperity surpassing that of its Caribbean neighbors, in addition to political stability. In its inception, this industrial development program was predicated on two tenets: low production costs, including low-wages, and tax incentives provided by Puerto Rico and Federal legislation.

Over the years, however, Puerto Rico's relative advantage over competing production sites outside the United States has been the subject of considerable erosion.

Since 1950, real wages in Puerto Rico have almost tripled due, in large measure, to the extension of the Federal minimum wage standards to the Island, union demands, and local and federally legislated employee benefits. Puerto Rico's labor costs are presently 3 to 5 times higher than those prevailing in competing foreign production sites.

More than 98% of all energy consumed in Puerto Rico is generated from imported petroleum. The escalation in oil prices from the levels which prevailed prior to 1973 caused local energy prices to skyrocket with a shock effect that has been felt by all economic sectors, manufacturing and non-manufacturing alike.

Puerto Rico's geographic location makes it almost exclusively dependent on maritime transportation for its imports and exports. Since Puerto Rico is part of the United States, it is required by law to utilize U.S. flag shipping, the most expensive in the world, for virtually all commerce. This factor has significantly contributed to Puerto Rico's inability to compete costwise with other foreign production sites.

Once its production cost advantages disappeared, Puerto Rico's industrial development program was left totally dependent on the tax policies of the United States and Puerto Rico.

Since 1976, Code Section 936, coupled with Puerto Rico's own tax incentives program, has been the decisive factor which has permitted Puerto Rico to attract and retain the manufacturing operations of U.S. firms. Without the tax incentives provided by Section 936, there is no doubt that such operations would have been established in or relocated to the Far East or Europe where lower operating costs and less expensive transportation costs are available.

Companies participating in the 936 program have made significant contributions to Puerto Rico's economy. In an island having an unemployment rate hovering in the 20% range, those companies directly account for approximately 90,000 of the total 140,000 existing jobs in the manufacturing sector of the economy; that is, 64% of the total employment force within that sector. In addition, those companies are accountable for, or have contributed to, a myriad of other indirect benefits including: well renumerated, more sophisticated and permanent jobs; additional indirect employment estimated at 26% of the total employed labor force; a higher and broader-based standard of living; a relatively good infrastructure; a per capita gross national income exceeding that of most countries in Latin America; and increased revenues for the Government of Puerto Rico.

It is evident that the 936 program is the critical element that has separated Puerto Rico's economic experience from that of our Caribbean neighbors. The continued success of the program depends entirely, however, on the existence of clearly defined and functional rules not subject to periodical and radical revisions. For that reason, we urge the members of this Finance Committee to preserve Section 936 in its present form.

H.R. 3838

Section 936 was last amended by the Tax Equity and Fiscal Responsibility Act of 1982. Now, three years later, there is once again a proposal to amend that section, incorporated as Section 641 of H.R. 3838, the House version of the tax reform bill. Such proposal, if adopted, will add such complexity to an already complex statute, and subject the 936 program to such contingencies, that its end result will be, for all practical matters, the termination of Puerto Rico's industrial promotions program.

Royalty Payments

Section 641 of H.R. 3838 provides that "possessions corporations" electing the "cost sharing" method for reporting active business income will be required to pay a cost sharing payment equal to the greater of: 1) the cost sharing payment presently provided in the law, increased by 10% or 2) the royalty payment ("Super Royalty Payment") that would be required under Code Section 367(d)(2)(A)(ii) and Code Section 482 if the possession corporation were a foreign corporation receiving transfers of intangibles from a related U.S. corporation. Such Super Royalty Payment would be required to be commesurate with the actual annual income stream atributable to the transferred intangible(s). The Super Royalty Payment provision would also impact possessions corporations electing the "profit split" method for reporting active business income.

The intended purpose of Section 641 of H.R. 3838 is to cause the reallocation of higher amounts of income attributable to the use of intangibles from possessions corporations to their U.S. parent corporations. It has been argued that U.S. parent corporations taxed by the United States have been unreasonably shifting income to their possession subsidiaries for the purpose of avoiding U.S. taxation.

If such abuses do exist, the Internal Revenue Service can correct same through the effective use of the already existing guidelines provided by Code Section 482, the regulations thereunder, revenue rulings, revenue procedures and case law. The Super Royalty Payment provisions being introduced by Section 641 of H.R. 3838, on the other hand, are void of clear and functional rules that will permit possessions corporations to adequately calculate such royalty. The House Ways and Means Committee Report on H.R. 3838 (hereinafter the "House Report"), for instance, indicates that, for calculating the Super Royalty Payments, industry norms or other unrelated party transactions shall not provide a safe harbor minimum payment for related party intangible transfers. Said House Report further states that the Committee does not intend that the inquiry as to the appropriate compensation for the intangible be limited to the question of whether it was appropriate considering only the facts in existence at the time of the transfer. The House Report goes on to say that the Super Royalty Payments made for intangibles shall require adjustment over time to reflect changes in the income attributable to the intangible.

Because of the absence of safe-harbors and the unreasonable discretion given to the federal taxing authorities to implement the Super Royalty Payments, it can be anticipated that any good faith effort on the part of the possessions corporations to quantify such payments would always be subject to attacks on the part of the Internal Revenue Service. In effect, therefore, the introduction of the Super Royalty Payments, as conceived in H.R. 3838, would inject a new basis for tax disputes between the taxing authorities and possessions corporations.

Based on the foregoing, the Association urges this Finance Committee to reject the Super Royalty Payments proposal as well as any other proposal that would inject uncertainty to Section 936 and undermine the success of Puerto Rico's industrial development program.

Caribbean Basin Investments

Another area of grave concern to this Association pertains to the apparent linkage that the House Report has established between the continuance of the 936 program and the Government of Puerto Rico's proposed investment program in the Caribbean Basin.

The House Report provides that, in deciding to make "relatively minor modifications" to Code Section 936, the House Ways and Means Committee was motivated in large part by representations on the part of the Government of Puerto Rico that it will vigorously pursue its twin plant initiative. The House Report goes on to say that the Memorandum of Agreement cited in the report provides, inter alia, that the Government of Puerto Rico will guarantee $100 million annually for private direct investment in qualified CBI countries, with such funds to be derived from various sources which include: possessions corporations, Puerto Rico Government Development Bank funds and grants by the Government of Puerto Rico.

While this Association is convinced that Puerto Rico's active involvement in the economic development of the Caribbean Basin is in the best interests of the entire Nation and, further, that the Government of Puerto Rico will make every possible effort to meet the challenge propounded by the House Ways and Means Committee, this Association strongly recommends that any shortfall in the $100 million annual investment figure set forth in the House Report not be used as justification for future legislative action geared towards the termination or amendment of the 936 program.

The Association hopes that if any linkage is ultimately established between the Section 936 program and Puerto Rico's investment plans for the Caribbean Basin, the success of such investment program be measured by reasonable standards; that is, by criteria recognizing: the fact that Puerto Rico is still at a developing stage and as such is in desperate need of substantial domestic capital investments; the fact that although Puerto Rico's economic situation is better than that of our Latin American neighbors, Puerto Rico's income per capita is less than one-half of that of the poorest State of the Union; the repayment capabilities of intended beneficiaries of Puerto Rico Government loans and other risk considerations; and, finally, the extent to which Puerto Rico's public finances would be placed in jeopardy as the result of the granting of injudicious loans. The Association requests that such standards of reason be included in the Senate Finance Committee's report if the Committee ultimately decides to amend the Section 936 program and, as part of such amendment, adopts the CBI linkage posture.

On behalf of the Puerto Rico Manufacturers Association I thank you again for the opportunity that you have granted us to express our views on the proposed tax reform legislation and pray that in reviewing the Section 936 program the Finance Committee be able to appreciate that the preservation of the program, as now in effect, is in the best interests of the Nation.

PUNAHOU SCHOOL
HONOLULU, HAWAII 96822

RODERICK F. McPHEE
President

February 14, 1986

Senate Finance Committee

I am writing to express my concern about TIAA-CREF and its long-standing federal tax exemption. I am very concerned that Section 1012 of H.R. 3838 would terminate this exemption, an action that I regard as highly unfair and discriminatory.

This would have a direct negative effect on my future retirement income, as well as those of a million other faculty members at American institutions.

I urge you not to permit this action to occur. Thank you for your attention to this matter.

Sincerely yours,

Roderick F. McPhee

cc: Senators Inouye and Matsunaga
Representatives Heftel and Akaka

Written Statement of
THE PURPA COALITION, INC.
Before the
UNITED STATES SENATE COMMITTEE ON FINANCE
Regarding
THE TAX REFORM ACT OF 1985
February 6, 1986

Mr. Chairman and Members of the Committee:

The members of The PURPA Coalition, Inc. (the "Coalition") appreciate the opportunity to submit written comments to the Finance Committee regarding certain trade implications of H.R. 3838, the Tax Reform Act of 1985. The Coalition is a non-profit corporation, a key purpose of which is to support the adoption of comprehensive national energy and tax policies which encourage cogeneration and alternative energy development nationwide.

The Tax Reform Act of 1985 (the "Act"), as passed by the House, would alter the relatively level playing field which exists under current law for investments in cogeneration and small power production, as compared to other investments in industrial property. The depreciation provisions of the Act actually would create a tax bias against investment in cogeneration systems, and thus would disadvantage energy-intensive domestic industries, such as paper, steel and refining, which otherwise could rely upon cogeneration as a means for improving their competitive position in the international marketplace. Similarly, the Act would treat investment in alternative energy projects less favorably than competing investments in comparable assets, and thus would make it more difficult for energy-intensive industries to take advantage of cost savings associated with the energy options particularly well suited to their respective geographic areas.

COGENERATION AND ALTERNATIVE ENERGY FACILITIES HELP ENERGY-INTENSIVE DOMESTIC INDUSTRIES TO BE COMPETITIVE

Cogeneration is the sequential production of both electrical (or mechanical) energy and useful thermal energy from the same primary energy source. Cogeneration systems recapture otherwise wasted thermal energy and use it for applications such as space heating or cooling, industrial process requirements, or water heating. While conventional energy systems supply either electricity or thermal energy, a cogeneration system provides both forms of energy to multi-family residential, commercial and industrial users.

Cogeneration is not a new technique for producing energy, and the equipment used in the design and development of cogeneration systems is not exotic. Cogeneration systems are composed of varied components -- including turbines, reciprocating engines, stoker-fired boilers, fluidized-bed combustors, waste heat recovery equipment, and related piping and wiring -- which often resemble those used in other industrial systems and which have varying useful lives.

A principal advantage of cogeneration systems is their ability to improve the efficiency of fuel use. A cogeneration facility, in producing both electrical and thermal energy, usually consumes more fuel than is required to produce either form of energy alone. However, the total fuel required to produce both electrical and thermal energy in a cogeneration system is significantly less than the total fuel required to produce the same amount of power and heat separately. Typically, ten barrels of oil, or an equivalent fuel, used in a cogeneration system will produce the same amount of electricity and thermal energy as conventional systems will produce when using thirteen barrels.

Because of these savings, cogeneration systems can lower the cost of electrical and thermal energy by 25 to 30 percent, even after the costs of equipment, maintenance, and other operating expenses are included. Cogeneration does not make economic sense in every situation, but it can provide important cost savings to manufacturing plants, commercial and other facilities.

The savings potential exists where there is a significant need for thermal energy and where energy costs comprise a major portion of production or operating budgets. For example, energy accounts for 30 percent of the materials cost of producing steel, and is an important part of the cost of production of glass, paper, cement and chemicals. As a result of the cost savings which it makes possible, cogeneration substantially reduces industrial energy costs, and thus helps to retain jobs, avoid plant closings and helps fight foreign competition.

Similarly, alternative energy facilities can help energy-intensive industries reduce their energy costs. Alternative energy facilities can take a number of forms. Generally, the type of alternative energy facility which is appropriate for a specific industry will depend on the energy needs of the industry and the alternative energy sources which are indigenous to the geographic area in which the industry is located. For example:

- ° Steel producers located in Pennsylvania and West Virginia could benefit from alternative energy facilities which use coal waste as an alternative energy source.
- ° Paper producers located in New York and the Pacific Northwest could benefit from alternative energy facilities which use water power as an alternative energy source.
- ° Aluminum producers located in the Pacific Northwest could also benefit from alternative energy facilities which use water power as an alternative energy source.

By taking advantage of such local alternative energy sources, which would otherwise remain unused, energy-intensive industries are able to produce energy in a cost efficient manner.

However, individual companies within a given industry often cannot take the lead in developing cogeneration or alternative energy facilities because such projects require large up-front capital investments. A cogeneration plant, for example, may cost $25 million, in comparison with $1.2 million for a regular steam boiler without cogeneration. While energy-intensive domestic industries are anxious to reduce their energy costs, their first order of investment must be in areas at the core of their businesses, such as the improvement or modernization of aging plants and production lines. Therefore, a substantial portion of the financing for cogeneration and alternative energy facilities must come from outside sources.

For cogeneration facilities to continue to attract third party investors, these facilities must be able to compete with other unregulated investments for the limited capital available.

THE ACT WOULD DISCOURAGE INVESTMENT IN COGENERATION AND ALTERNATIVE ENERGY FACILITIES

Current Law Distinguishes Between Utility and Nonutility Property

Under current law, cogeneration and alternative energy facilities are depreciated under the Accelerated Cost Recovery System ("ACRS"). Under ACRS, the cost of tangible business property is recovered over a "recovery period" of 3, 5, 10, 15 or 19 years, depending on the type of property involved. The cost of property in each category may be recovered under a statutory schedule based on the 150% declining balance method of depreciation. Taxpayers have the option to elect straight-line depreciation over the recovery period, or over specified longer periods, in lieu of the statutory schedule. Currently:

- Most components of cogeneration and alternative energy facilities are included in the 5-year property category, and are allowed depreciation of 15% during the first year, 22% during the second year, and 21% during the third, fourth and fifth years.
- Cogeneration and alternative energy facilities which are classified as building components are included in the 19-year real property category and are depreciated over a longer accelerated schedule.

However, special rules are provided under ACRS for property classified as "public utility property." Public utility property generally consists of property used in the business of providing utility-type services, including electricity, if the rates for the service have been established or approved on a rate of return basis by a governmental body. Currently:

- ° Items of public utility property whose guideline life under the Asset Depreciation Range ("ADR") depreciation system [1] was between 18 and 25 years are included in the 10-year category, and public utility property for which the guideline life was 25 years or more are included in a special 15-year utility property category.
- ° Cogeneration and alternative energy projects whose output is sold under regulated rates could be subject to the special rules for public utility property. However, because the rates for cogenerators and small power producers which are qualifying facilities under the Public Utility Regulatory Policies Act ("PURPA") are based on the purchasing utility's avoided cost, rather than the producing facility's cost of service, cogeneration and small power production facilities which are qualifying facilities under PURPA are not classified as utility property.

The Act Would Remove The Utility/Nonutility Distinction

The Act would replace ACRS with a new depreciation method -- the Incentive Depreciation System ("IDS"). Under IDS, a depreciable asset would be included in one of ten asset categories depending on the guideline life of the asset under the ADR system:

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[1] Under the ADR depreciation system, which was in effect prior to the enactment of ACRS in 1981, assets were assigned guideline lives for depreciation purposes based on the expected useful life of similar assets.

- Gas turbine and diesel cogeneration systems, which had a 20-year guideline life under the ADR system, would be included in Class 7, with a 20-year depreciation period and a 10% rate. [2/]
- Other cogeneration and alternative energy facilities, such as waste-to-energy facilities, which had an ADR guideline life of 28 years, would be included in Class 8, with a 25-year depreciation period and a 8% rate.
- Hydroelectric generating projects, and cogeneration and alternative energy facilities classified as building components under current law would be included in Class 10, with a 30-year recovery period and a 3.33% rate.
- Wind and photovoltaic energy equipment would be included in Class 4, with a 10-year depreciation period and a 20% rate, under a special provision in the Act.

It should be noted that wind and photovoltaic energy equipment would be included in Class 4 because they did not have a class life under the ADR system. This classification creates an arbitrary distinction between these forms of alternative energy and other forms of alternative energy which would be depreciated over longer recovery periods.

[2/] While the depreciable lives are longer under the IDS system, the effect of these longer lives is offset by the use of more accelerated depreciation rates, based on the 200 percent declining balance depreciation method.

The Act Would Treat Alternative Energy and Cogeneration Less Favorably Than Competing Investments

The Act would eliminate the relatively level playing field for cogeneration and alternative energy investment which exists under current law. Today, tax benefits are not a consideration in choosing between cogeneration or alternative energy facilities and other investments against which these facilities must compete for capital. A manufacturer or other potential investor may therefore choose the energy system which best meets its needs, without fearing that it will, in effect, be faced with a tax penalty. By contrast, the Act would build into the Internal Revenue Code a bias against cogeneration and certain forms of alternative energy by providing more favorable depreciation treatment to the property against which these facilities must compete for capital. For example, cogeneration and alternative energy facilities must compete against the following types of equipment, which would receive more favorable depreciation treatment under the Act, for investment capital:

- Most production line manufacturing equipment, which had guideline lives under the ADR system ranging from 8 to 13 years, would be included in Classes 3 and 4, with a 7- or 10-year depreciation period and a 28.57% or 20% rate. [3/]
- Commercial airplanes, and Waste Reduction and Resource Recovery Plants, which had 12-year guideline lives under the ADR system,

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[3/] Examples of such production line manufacturing equipment are equipment used in the production of: textured yarns (8 year guideline life); carpets, and dying, finishing and packaging textile products (9 year guideline life); wood products and furniture (10 year guideline life); finished plastic products (11 year guideline life); and pulp and paper (13 year guideline life).

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would be included in Class 4, with a 10-year depreciation period and a 20% rate.

- Railroad freight train cars, which had a 14-year guideline life under the ADR system, would be included in Class 5, with a 13-year depreciation period and a 15.38% rate.

Such a bias is unsupportable as a matter of tax, economic and industrial policy.

The Act is particularly unfair because certain pieces of equipment standing alone would be treated differently, and more favorably, than they would be treated when integrated into a more energy-efficient cogeneration or alternative energy facility. For example, boilers and other combustion related equipment, if independently installed for certain industrial or commercial applications, would qualify as Class 3, 4 or 5 property. However, the same equipment would be considered Class 7, 8 or 10 property if included as components of a cogeneration or alternative energy facility.

The disparate treatment arises in part from the Act's reliance upon the ADR system, which was conceived and created before 1978, the year which marked the real beginning of the development of the alternative energy and cogeneration industries. The ADR system assumed investments in energy facilities were being made in large-scale, long-lived facilities which consisted mainly of structural components. However, investments in today's alternative energy facilities are directed more toward equipment which in many ways is comparable to other industrial equipment. For example, in the past when hydroelectric facilities were developed the majority of the investment required involved the construction of a dam, and only a small part of the investment involved equipment. But today, most of the development of hydroelectric facilities involves the refurbishment of existing dam sites or development in locations which do not require the construction of large structures. As a result, 50% or more of the investment required to develop a hydroelectric facility today, is directed toward the acquisition and installation of equipment which is similar to equipment used in many manufacturing and production plants.

Another consideration is that the Act, like other tax reform proposals which have been presented, would remove the distinction for depreciation purposes between nonutility cogeneration and alternative energy facilities and regulated utilities from the Code, even though the investment considerations of regulated and unregulated electric producers (including unregulated utility subsidiaries) are very different. A public utility's investment decisions are dictated primarily by the pattern of electric demand within the utility's service territory. Because regulated electric utilities are guaranteed a return on their investment, the tax consequences of their investments do not play nearly as significant a role in utilities' investment decision-making as they do in the investment decisions of unregulated companies, which must compete with other unregulated investments for capital. Because of this difference, electric utilities have traditionally been assigned a lower depreciation rate than nonregulated electric producers.

CONCLUSION

For energy-intensive domestic industries to improve their competitive position in the international marketplace, they must be able to take advantage of more cost-efficient energy sources. Cogeneration and alternative energy facilities provide this opportunity. However, the imposition of a bias against investments in these facilities in the Internal Revenue Code, will reduce the capital available to invest in these facilities. As a result, high energy costs will continue to burden energy-intensive domestic industries which must compete in the international marketplace.

Under current law, cogeneration and alternative energy facilities are included in the five-year ACRS category, while public utility generating equipment is included in the ten- or fifteen-year ACRS categories. Cogeneration and alternative energy facilities, which are exposed to the same entrepreneurial risks as other business investments, should continue to be accorded depreciation treatment comparable to that accorded other unregulated investments. They should not be treated like regulated utility investments.

Accordingly, the Coalition urges the Committee to revise the IDS categories so that an arbitrary distinction is not created between cogeneration and alternative energy facilities and comparable industrial equipment against which they must compete for capital. Furthermore, the Act should also not create an arbitrary distinction between different forms of alternative energy facilities, but should include cogeneration and other alternative energy facilities in the same IDS class as wind and photovoltaic energy equipment.

SUPPLEMENTARY STATEMENT

submitted by

THE REINSURANCE ASSOCIATION OF AMERICA

on

THE EFFECTS OF HR 3838 ON THE COMPETITIVE POSITION OF THE DOMESTIC REINSURANCE INDUSTRY

DRAFT
1/29/86

The Honorable Bob Packwood
Chairman, Committee on Finance
United States Senate
Washington, D.C. 20501

Dear Mr. Chairman:

The Reinsurance Association of America represents the domestic professional reinsurance industry. Its members are property and casualty insurers in the business of assuming reinsurance and are either domestic U.S. companies or U.S. branches of foreign reinsurers entered through and licensed by a state. All these companies are subject to the regulatory jurisdiction of the various states in which they are domiciled or licensed and they are all U.S. taxpayers.

In prior testimony (October 1, 1985) before the Senate Finance Committee, we suggested that certain changes to the tax structure of p/c insurers would have serious adverse consequences for domestic reinsurers which are taxed as p/c insurers. Specifically, we noted that if the Administration proposal (QRA) were to be enacted, domestic reinsurers would need to increase their prices in excess of 10% . This would leave domestic reinsurers at the mercy of their foreign competitors since these would not be subject to the U.S. tax. We pointed out that reinsurance is an extremely fungible product, as evidenced by the existing international reinsurance market and that already today, without any additional tax advantages favoring alien companies, the current annual (1983) net U.S. Balance of Payment reinsurance deficit amounts to $505.8 million*. Our October 1, 1985 statement depicted the anticipated changes in economic behavior which would result from the imposition of such a major new tax burden on the domestic industry and we conservatively projected that the Administration's proposal would result in an additional annual outflow of capital amounting to $9.8 billion*.

Additionally, we predicted that the domestic reinsurance industry's growth would be slowed and the lack of increased domestic capacity would lead to a serious delay in the recovery of the entire p/c insurance industry market.

We have now carefully examined the impact of HR 3838 on domestic reinsurers and although not as dramatic as the Administration's proposal, we anticipate its enactment would likewise lead to major shifts in assets, premiums and equity offshore. For instance, although we would anticipate that on average reinsurance premium increases would be less than those which would be required under the Administration plan, HR 3838 would still force domestic reinsurers to raise the price they charge primary insurers for p/c worker's compensation reinsurance coverage by 10.9%; for general liability reinsurance coverage 9.4%. Since there is little to prevent primary companies from purchasing their reinsurance needs abroad, only the available alien capacity will act as a deterrent to a shift away from domestic markets. As noted in our October, 1985 statement, such capacity would readily become available as foreign reinsurers would close their U.S. domestic subsidiaries (current U.S. taxpayers), and transfer both the business and the equity of those subsidiaries back to the parents. Incidentally, it must be recognized that the anticipated (although not often realized) profit in reinsurance contracts is not nearly enough to allow domestic reinsurers simply to absorb the additional tax burden imposed by HR 3838.

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* This number represents the actual net outflow of U.S. dollars to foreign reinsurers and is derived by deducting from the premium paid for reinsurance coverage by U.S. insurers to foreign companies, less reimbursement by those foreign companies for losses incurred by U.S. companies under these reinsurance contracts the premium paid U.S. reinsurers by foreign insurers for reinsurance protection, less the payments by U.S. reinsurers to those foreign companies as reimbursement for losses incurred under those reinsurance contracts (see Appendix A, 10/1/85 statement).

Perhaps the House believes that the changes which it proposes to the excise tax (Sec. 654, amending Section 4371 of the code) would level the current competitive position between domestic and alien reinsurers. The excise tax today imposes a 1% of premium levy on p/c reinsurance transactions between U.S. and alien companies. This tax, however, is waived in many instances as a result of the treaties the U.S. has signed with foreign countries. Further, the treaty with England has been interpreted to allow a waiver of any premium which is consequently reinsured by an English company, even if the reinsurance is with a company located in a non treaty country; thus, inviting British reinsurers to "front" for non treaty countries' reinsurers.

HR 3838 would increase the excise tax from 1 to 4% of premium and would limit the "waiver" to reinsurance premium ceded or retroceded to treaty countries only. True, these provisions of the House bill (which, incidentally, we believe are administratively unenforceable) would theoretically ban the current particular advantages of English companies, but the current competitive edge of alien reinsurers domiciled in treaty countries would not be lessened -- in fact, HR 3838 would increase the advantage of these companies vis-a-vis non treaty countries' companies.

Clearly, HR 3838 does not deal with the benefits to certain alien reinsurers under the tax treaties by amending the excise tax provisions of the code.

Still, we are convinced that there are ways to maintain the international competitive position of the domestic reinsurance industry and simultaneously impose an additional and fair tax burden on p/c insurance companies.

Our proposal envisions a "permanent solution," contrary to HR 3838, as to the taxation of p/c insurers. The p/c insurance business is today going through its most difficult period in its entire history. In addition to the chilling losses which the companies have sustained in the recent past and which are continuing to the present, their ability to meet the needs of our economy has been handicapped by the explosive changes in our civil justice system. Industry leaders are facing many survival challenges today, but the solution to these challenges only partially lay within their control. Now is not the time to consciously impose additional future uncertainties by leaving the companies in the air by enacting what is represented as only a new stop gap tax program applicable to them.

We urge that a long term resolution of the p/c tax issues be enacted by Congress this year in the combined interest of the industry, its customers and the U.S. Treasury.

We propose the following multifaceted program which will provide the additional revenues sought by the Administration from the industry in a manner which we perceive as fair treatment for the industry:

1. The Administration and the House have targeted the p/c insurance companies for an additional $4.5 billion in tax revenue over the next 5 years. We believe that this will be achieved by the enactment of Section 1021 and 1022 of HR 3838, which we can support. As an alternative, we suggest for consideration amending Section 1021 by increasing the percent of unearned premium to take in as current income from 20 to 25 as a substitute for Section 1022 which would be dropped. Section 1022 imposes a limited tax on tax exempt income, but since we propose in the following section a tax on a company's total net income, including tax exempt income, Section 1022 might be viewed as double taxation of tax exempt income.

2. The Administration proposed that the p/c insurance industry be responsible for approximately $1 billion additional taxes per year. This goal will be achieved for the next 5 years if either alternative described in the preceding section is enacted. But, what about the "out years?" We admit that the tax revenues generated by Section 1021, either as contemplated in HR 3838 or amended as above would fall off significantly after 5 years. Therefore, we propose that those revenues be further enhanced by imposing on the p/c insurance

industry an alternative minimum tax, as a permanent tax. This new tax would be based on 20% of line 18(b) of the uniform NAIC annual statement required to be filed by each company with state regulators, with a cap on this alternative minimum tax at 1% of the company's net written premium, or a cap of equivalent effect utilizing any other reasonable measure. Line 18(b) -- which is already incorporated in an alternative format in HR 3838 -- is a true reflection of the company's net income and includes underwriting gain, as well as investment income, including that generated by all tax exempt securities and realized capital gains.

Briefly, this is the manner in which this alternative minimum tax would operate. A p/c insurance company would calculate its tax liability, as it does today, and as augmented by the unearned premium and, if applicable, tax exempt income provisions noted above. If for any taxable year the tax so derived would be less than the alternative minimum tax described above, the company would owe the difference as an additional tax. The company would not, however, reduce its normal tax if the alternative tax liability were to be of a lesser amount. If line 18(b) shows a loss in any one year, the company would not be allowed to use this loss in future years to reduce the tax liability generated through this alternative method. However, the company would be authorized, as is the case today, to utilize current and future NOL's to reduce a tax liability calculated under the regular tax provisions. If this proposal were adopted, substantial new revenue would be raised from p/c insurers which would be based largely on their entire net income.

We urge the Committee to verify with Treasury or the Joint Committee the level of anticipated new revenue which the above would generate. Analysts who have followed the fortunes of the p/c insurance industry forecast that some degree of profitability will return in 1986 and that there will be continued improvement through at least 1988. Further, we foresee a major expansion of premium writing from the current basis (1984: $116 billion).

What is proposed here meets the duel objective of increasing revenue from the p/c industry and responding to demands for "reform" of its tax structure.

We have discussed additional revenues above. As to "reform," it should be noted that this proposed tax scheme deals with the principal concerns expressed by most critics of the current tax structure of p/c insurers. They allege that the industry avoids its fair share of the nation's tax burden by being allowed to "mismatch" income and expenses and by protecting its income by deriving enormous amounts of investment gain from tax exempt securities. Further, they say, that since the industry as a whole has accumulated large amounts of NOL's, it will continue to be able to avoid any actual payment of federal taxes for many years to come. Finally, they have said that consolidation between p/c insurers and non insurance entities results in substantial loss of tax revenue since a non insurance entity is able to reduce its tax burden as a result of consolidation.

HR 3838 attempts to deal with these concerns. Section 1021 corrects the "mismatching" concerns and Section 1022 imposes a limited tax on tax exempt income. As noted above, we believe that those two sections are reasonable.

Section 1023 goes to the issues of NOL's and consolidation. What is proposed in the House bill would effectively disqualify the use of any accumulated NOL's and would likewise nullify the tax implications for a p/c company of consolidation. We believe that it is grossly unfair to single out p/c insurers in this fashion. Adequate revenues can be generated from the industry without imposing such a punitive result on this industry alone among all others.

Yet, we are sensitive to the criticisms which have been leveled and what we have proposed in total will limit the availability of current NOL's and will also disqualify some of the tax benefits acquired through consolidation.

3. We urge that Section 1027 of HR 3838 be eliminated. This calls for additional studies of the tax treatment of loss reserves. This is an issue which has been under review by Treasury and GAO for several years and is the subject of an extensive report by GAO. Whether loss reserves should be discounted, the method of discounting, the threat of insolvency were loss reserves required to be discounted, and many other facets have been discussed at length and it is inconceivable that

new evidence or knowledge could be unearthed through this proposed study. The plan we suggest above obviates the need for any further disagreement about the loss reserve issue by focusing on a broader, all-inclusive taxable income (net income) approach for tax purposes. We urge that the "discounting" issue be tabled, once and for all, and that such a nefarious proposal, with its underlying threat to the entire solvency of the p/c insurance industry be resolved by focusing on the industry's net income as the proper basis of taxation.

4. To equalize the competition with alien insurers, we propose that they be subject to an equivalent to the minimum tax. We are tentatively suggesting that all insurance and reinsurance premium paid an alien company be subject to a 1% withholding tax. If the premium collected by the alien company is subject to the U.S. income tax because the alien company files a U.S. tax return, an offset against its U.S. tax liability would be allowed for the withheld amount. Such a withholding provision has precedent in the code and parallels the treatment of U.S. investment income earned by a non resident alien. We are presently researching whether such a tax could be held to be an excise tax, subject to the waivers of tax treaties. We are also reviewing

other alternatives to tax alien companies in order to equalize the competitive edge over the domestic industry such companies will enjoy if HR 3838 is enacted in its present form. We will share this review with the Committee as soon as it is completed.

In closing, the amendments we are proposing to HR 3838 would:

- Provide predictable additional revenues to the government.
- Such revenues to be paid by p/c insurers in a manner which would be fair on the industry, competitively neutral within the industry and simple to administer,

and

- Would allow the domestic reinsurance industry to maintain its current competitive position in the marketplace.

Respectfully submitted,

Andre Maisonpierre
President

AM:ld

cc: All Members of the
Finance Committee

STATEMENT OF
THE RETAIL TAX COMMITTEE OF COMMON INTEREST
SUBMITTED TO
THE COMMITTEE ON FINANCE
UNITED STATES SENATE

February 20, 1986

"Hearings On Tax Reform"

INTRODUCTION

The Retail Tax Committee of Common Interest is comprised of the chief executive officers of major retailing companies and their major retail trade associations. Attached are the names of the executives on whose behalf this statement is submitted.

The Retail Tax Committee urges the Finance Committee to adopt promptly a comprehensive tax reform package which is based on the substantial tax rate reductions that have been proposed by the President.

The need for such a change in the income tax laws has been building steadily for a number of years. There is an apparently increasing level of public dissatisfaction with a system that is perceived to be unfair and which has resulted in the growth of a large "underground economy." Unfairness is manifest in the wide divergence in burdens which present law imposes on various business sectors of the economy as reflected in those sectors' effective tax rates. The retail industry -- which has historically paid taxes at high effective rates -- is particularly affected by this disparity.

I. Support For Fundamental Tax Reform

Retailing has long favored a general tax reform effort which substantially reduces high tax rates on both individuals and businesses. Our support for the current initiative has been expressed repeatedly since the President proposed his overall tax reform package in May 1985. Our views were presented to the House Ways and Means Committee in June 1985, and we continued to work in support of tax reform both in that Committee and on the House floor. Although there are matters of concern to the retailing industry in H.R. 3838, we urged its adoption on the House floor.

From retailing's perspective, a tax reform measure must contain four critical elements:

(1) reduction in the top corporate tax rate to 33% and retention of graduated rates for smaller companies;

(2) a reduction in individual tax rates to the 15%, 25% and 35% rates proposed by the President, thereby increasing consumers' disposable income as well as their ability to save and invest;

(3) an adequate deduction for a portion of dividends paid; and

(4) sufficient recognition of the importance of private sector responses to retirement security, health and insurance needs of our employees.

One general caveat which we have expressed from the outset is that no specific reform proposal should have a particularly adverse effect on retailers. If these criteria are met, we support enactment of a major tax reform package in 1986.

II. Corporate Tax Rate Reduction

Our industry's primary concern in tax reform is a substantial reduction in the current 46% corporate tax rate. The President's proposal calls for an immediate reduction of 13 percentage points, thus bringing the top rate down to 33%. The House bill stops short of this goal, reducing the rate only to 36%.

A reduction of the top rate to 33% must be retained as the central theme of the corporate provisions of a tax reform package. If the corporate rate remains at 36% or moves higher in exchange for other provisions, Congress will not have seized the opportunity to enact comprehensive reforms rather then piecemeal, highly selective reforms.

A. Benefits Of Lower Tax Rates

Most of the attention given to the business provisions of H.R. 3838 has focused on the adverse effects of specific reforms. While such analysis may be useful and informative, retailers are distressed to see that relatively little consideration is being given to the benefits of rate cuts. It is inappropriate and misleading to address specific proposals outside the context of the total package which includes substantially lower tax rates.

There will be several beneficial effects following a substantial reduction in top tax rates. The overall long-term economic benefit of substantial tax rate reductions will be a parallel reduction in the impact which the heavy hand of high rates has on the millions of business and personal financial decisions which are made each day. The rate of tax which a person expects will be imposed on the income from making additional investments or from providing more hours of personal labor certainly affects his or her willingness to do that which is otherwise economically sound.

This effect may be so direct and strong as to lead the individual or the business manager to forego doing something because the benefit no longer outweighs the combination of time, resources and taxes which it will cost. Or, more likely, the taxpayer seeks to lessen the tax bite on work and investments by taking actions which do not make sense otherwise. "Tax shelters" for individuals and lease financing subsidaries for many corporations are examples of perfectly rational responses to high tax rates on individuals and corporations.

The inefficiencies of such tax-motivated transactions are apparent. The repeated news reports of overbuilt and underutilized commercial buildings, the pages of newspaper advertisements shouting "TAX SHELTERS!," the proliferation of professionals who earn substantial incomes from legal tax avoidance planning -- all of these are examples of the impact of high tax rates. These economic inefficiencies should be attacked directly and fundamentally by reducing high tax rates, as well as through the traditional "loophole closing" amendments.

The overriding benefit of a lower corporate tax rate will be a significantly smaller tax burden on each dollar which a corporation earns as profit. The reduced tax rate will allow more of the corporation's earnings to remain available for investment in jobs, inventory and structures which enable retailers to serve as the vital link between manufacturers and consumers.

Corporate income tax rate reduction will also lessen the current law's bias which urges a corporation to finance its activities through debt, on which interest is deductible, rather than through equity issues, on which dividends are not deductible. Deducting interest against a 46% tax rate dramatically cuts the real cost of debt relative to dividend-paying equity. A 33% tax rate will at least reduce the imbalance between debt and equity, making the latter more attractive than is now the case.

For example, the corporation which is considered by lenders and equity markets alike to be a quality risk could choose to seek new capital either through additional debt or through a new offering of stock. Assume interest costs would be 10% a year, while dividend payouts would be about 7% of new equity proceeds. Interest is deductible, so the after-tax cost of debt to the corporation would be 5.4% per year. The non-deductible dividends would cost a full 7% in after-tax dollars. When the tax rate is reduced from 46% to 33%, the after-tax cost of interest payments in the example rises from 5.4% to 6.7%. Thus, the gap between the cost of equity and the cost of debt is narrowed by the simple act of a substantial reduction of the tax rate. Arguably, this could lead to either lower interest rates (if demand for debt were lessened) or increased dividends (as after-tax earnings increased) or some mix of the two, depending upon one's view of economic theories. But at least one result should be clear -- a substantial rate reduction can do much to lessen the artifical, tax-induced preference for debt over equity financing.

A third benefit will be a general lessening of the economic value of the whole range of business deductions and credits. In an era of very high tax rates, particularly when coupled with a period of high inflation, the availability of special deductions and credits becomes a primary factor in business planning. A 13 percentage point reduction in the corporate tax rate should reduce significantly the impact of tax consequences on business decision making. To the extent that human and financial resources are not diverted to tax-motivated activities (*e.g.*, leasing), they can be devoted to the business needs of the company in order to increase productivity and sales, plan efficient investments in capital assets, and so forth.

B. Graduated Rates For Smaller Corporations

One essential element for a desirable tax reform package is the retention of lower rates for smaller corporations. While the larger retailing companies do not benefit from the current graduated rates, the vast majority of retailers -- representing some 80 percent of our industry's sales -- are small businesses. For those companies, rates on the first $75,000 of income which are significantly lower than the top rate are essential to generate a higher level of retained earnings. These earnings are the new capital that is either otherwise inaccessible (e.g., from equity and bond markets) or very expensive (such as commercial bank loans.)

The House bill achieves the desired result by retaining graduated rate brackets and reducing the rates on all income above $25,000. These provisions should be retained.

III. Partial Deductibility of Dividends Paid to Shareholders

Of critical interest to our industry is the President's proposal to allow a partial deduction for dividends paid to shareholders, provided that the corporation has already paid tax at the full corporate rate with respect to the earnings which are paid as dividends. Enactment of a meaningful dividend deduction would be a very important step toward eliminating the economic inefficiencies of the double taxation which is imposed on income from investments in corporations.

However, we are disappointed that the President has proposed to restrict the deduction to only 10% of dividends paid, and that the House bill further restricts this proposal by requiring a 10-year phasein of that 10% deduction. The House bill should be liberalized significantly.

IV. Taxation of Employee Benefits

Retailing is a highly labor-intensive industry whose primary resource is its people. For that reason, we are concerned with the impact of tax reform on employee benefits such as pensions and health care.

The House bill removed much of the most objectionable features of the President's original proposals. However, more remains to be accomplished. In particular, we urge the restoration of the major benefits of sec. 401(k) plans to assure their continued viability to retailing employees.

V. Installment Sale Treatment For Revolving Credit Plans

Like other industries, we recognized that tax reform legislation would restrict provisions of current law which are beneficial to retailers, in conjunction with reducing tax rates. One such provision in H.R. 3838 is the proposed treatment as current income of the proceeds of loans for which installment obligations are pledged as security. This would significantly change the existing installment sale treatment of our revolving credit plans. We were prepared to accept a change in this area.

However, several features of the provisions in sec. 903 of the House bill should be revised. Many are technical in nature;

these are being discussed initially with Committee staff and Treasury. Three substantive matters require the Committee's attention.

A. The Concept of "Pledged" Installment Obligations

The first concerns the concept of the proposal itself. Since Treasury I was published, the stated purpose of the rule has been to treat as current income the proceeds of a loan for which an installment obligation is pledged as security. Certain circumstances in which such obligations are clearly the assets to which a lender is looking but which are not directly pledged were also clearly intended to be subject to the rule. This concept of pledged and indirectly pledged installment receivables should be the foundation of the new provision, and specific rules should be drafted to provide a mathematical safe harbor which shields a company's receivables. The House bill provides such a safe harbor when a company's active trade or business assets (excluding receivables) comprise more than 50% of its total assets. This test should be retained and its technical features clarified.

B. Exclusion For Payments Within 12 Months

A second problem is the "nine-month rule." When installment receivables are subject to the new provision, the nine-month rule allows the company to remove from the computations those amounts which its customers will pay within nine months of the sales which give rise to the obligations that are treated as pledged. This period should be raised to a minimum of 12 months. The variations in purchasing and payment habits of customers over the entire calendar year should be taken into account when making the computation. A nine-month rule is too short a period.

C. Transition Rule

The third problem deals with the "transition rule." The new provision would create a very substantial one-time tax increase in its first year, attributable to the immediate taxation of deferred income which has built up under installment sale rules over a period of years. Subsequent annual tax increases would be limited to much smaller one-year increments.

Such a major change in accounting rules should be accompanied by at least a five-year spread for the payment of the massive first-year increase. The House bill nominally allows three years, but in practice it is very little more than a one-year transition. Furthermore, since most retailers close their taxable year in January or February (rather than December 31), the transition rule in the House bill would impose a significant tax increase for FY '86, which has now ended.

VI. Equitable Cost Recovery

Retailing has been particularly disfavored by cost recovery rules because our buildings have been denied the investment credit and have been subjected to lengthy depreciation periods. As part of the substantial change in cost recovery rules in a tax reform bill, buildings should not continue to be the subject of such discrimination. Furthermore, our retailing buildings --

which are capital equipment, not inventory items or investment assets -- should not be treated like the buildings of the real estate industry for federal tax policy purposes.

If the Committee liberalizes the depreciation provisions of H.R. 3838 for machinery and equipment, the treatment of buildings should also be improved for retailers whose buildings are active business assets.

VII. Conclusion

For several decades, new deductions and credits periodically have been added to the tax laws, and existing ones expanded. Each of these actions was made in a good faith effort to provide a measure of relief for certain groups or to encourage taxpayers to take certain actions.

But what has resulted is difficult to justify. The tax laws are now used as a kind of national industrial policy to entice a wide variety of taxpayers into making business decisions because of the favorable tax consequences.

The incentive effects of these deductions and credits have become effective only because they are a means for avoiding high tax rates. But there are now so many of them that the 46% corporate rate is applied to relatively little corporate income, and effective tax rates are widely divergent among various industries.

Now it is time to reduce -- if not eliminate -- the use of the tax laws as an allocator of capital and labor in our economy. We must allow the economic marketplace to serve this purpose by moving toward an income tax which imposes substantially lower rates on a broader base of income. Such a system will reshape the way businesses, investors and consumers alike approach our economic decisions, allowing all of us to direct our resources as markets dictate, making the most of what we invest and spend. Lower rates will yield a higher rate of economic growth and ivnestment, compliance with the law, and prosperity.

CEOs OF THE RETAIL TAX COMMITTEE OF COMMON INTEREST

Joseph Berzok
BATUS INC.

David C. Farrell
Chairman of the Board and CEO
THE MAY DEPARTMENT STORES COMPANY

Edward S. Finkelstein
Chairman of the Board and CEO
R. H. MACY & COMPANY, INC.

Howard Goldfeder
Chairman of the Board and CEO
FEDERATED DEPARTMENT STORES, INC.

Philip M. Hawley
Chairman of the Board and CEO
CARTER HAWLEY HALE STORES, INC.

William R. Howell
Chairman of the Board and CEO
J. C. PENNEY COMPANY, INC.

Joseph H. Johnson
Chairman and Chief Executive Officer
ASSOCIATED DRY GOODS CORPORATION

Thomas M. Macioce
President and CEO
ALLIED STORES CORPORATION

Kenneth A. Macke
Chairman of the Board
THE DAYTON HUDSON CORPORATION

Peter S. Willmott
President and CEO
CARSON PIRIE SCOTT & COMPANY

American Retail Federation

National Retail Merchants Association

R

THE
RETIRED
OFFICERS
ASSOCIATION
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STATEMENT OF

LIEUTENANT GENERAL LEROY J. MANOR, USAF, RETIRED

PRESIDENT OF THE RETIRED OFFICERS ASSOCIATION (TROA)

presented to the

UNITED STATES SENATE

Committee on Finance

Hearings on HR 3838

on January 29, 1986

"New subjects included in HR 3838 but not proposed by the
Reagan Administration last year"

MR. CHAIRMAN AND MEMBERS OF THE COMMITTEE:

I AM LIEUTENANT GENERAL LEROY MANOR, USAF, RETIRED, PRESIDENT OF THE RETIRED OFFICERS ASSOCIATION (TROA) WHICH HAS ITS NATIONAL HEADQUARTERS AT 201 NORTH WASHINGTON STREET, ALEXANDRIA, VIRGINIA. OUR ASSOCIATION HAS A MEMBERSHIP OF OVER 345,000 RETIRED, FORMER AND ACTIVE DUTY OFFICERS OF THE SEVEN UNIFORMED SERVICES. INCLUDED IN OUR MEMBERSHIP ARE 41,577 WIDOWS OF FORMER MEMBERS.

THE PURPOSE OF THIS PRESENTATION IS TO STRONGLY ENDORSE SECTION 144 OF HR 3838, TAX REFORM ACT OF 1985. THAT SECTION ADDS A NEW SUBSECTION (6) TO SECTION 265 OF THE CODE TO PROHIBIT APPLYING THAT SECTION TO PARSONAGE AND MILITARY HOUSING ALLOWANCES.

THE EFFECT OF THIS PROVISION IS TO OVERRULE INTERNAL REVENUE RULING 83-3 WHICH WOULD HAVE PROVIDED THAT HOME MORTGAGE INTEREST AND REAL PROPERTY TAXES PAID BY MEMBERS OF THE CLERGY AND OF THE MILITARY WOULD BE REDUCED BY THE PARSONAGE AND HOUSING ALLOWANCES THOSE MEMBERS RECEIVE. BECAUSE OF THE UNFAIRNESS OF THE RULING, CONGRESS HAS INTERVENED TO DELAY THE EFFECTIVE DATE OF THE RULING ON SEVERAL OCCASIONS.

OUR EXPERTISE IS PRIMARILY IN THE AREA OF THE UNIFORMED SERVICES AND WE WILL LIMIT OUR REMARKS TO THE DEDICATED MILITARY MEN AND WOMEN WHO HAVE SERVED, AND CONTINUE TO SERVE, THIS NATION SO SELFLESSLY. HOWEVER, WE ARE CONVINCED THAT AN EQUALLY COMPELLING RATIONALE EXISTS FOR MEMBERS OF THE CLERGY.

BY WAY OF BACKGROUND, SINCE 1983 THE INTERNAL REVENUE SERVICE

(IRS) HAS BEEN CONSIDERING A MAJOR CHANGE IN POLICY WHICH WOULD DENY MILITARY MEMBERS OF THE RIGHT TO CLAIM MORTGAGE INTEREST AND REAL ESTATE TAXES AS ITEMIZED DEDUCTIONS TO THE EXTENT THOSE EXPENSES ARE PAID FROM THE BASIC ALLOWANCE FOR QUARTERS (BAQ) AND THE VARIABLE HOUSING ALLOWANCE (VHA). FOR EXAMPLE, IF A MEMBER HAD MONTHLY MORTGAGE INTEREST AND REAL ESTATE TAX PAYMENTS THAT TOTALED $700 AND HIS BAQ AND VHA AMOUNTED TO $500, ONLY $200 COULD BE USED AS AN ITEMIZED DEDUCTION.

THE SECRETARY OF DEFENSE, THE JOINT CHIEFS OF STAFF AND SEVERAL MEMBERS OF CONGRESS STRONGLY OPPOSE IRS RULING 83-3. IF IMPLEMENTED, MORE THAN 290,000 MILITARY HOMEOWNERS WOULD EXPERIENCE AN INCREASE IN TAXES EQUIVALENT TO A 3 TO 6 PERCENT PAY CUT (RANGING FROM $1,000 TO $3,000 PER YEAR). THE RULING IS TARGETED PREDOMINATELY AT THE CAREER FORCE (80 PERCENT OF THOSE AFFECTED ARE CAPTAIN/LIEUTENANT [O-3] OR BELOW AND WOULD HAVE AN EXTREMELY NEGATIVE EFFECT ON RETENTION AND COMBAT READINESS.

THE SERIOUS DEGRADATION OF SERVICE MORALE THAT WOULD RESULT FROM IMPLEMENTATION OF THE RULING IS A PARAMOUNT CONCERN. NUMEROUS INEQUITIES BETWEEN SERVICE MEMBERS WOULD RESULT FROM IMPLEMENTING THE INTERNAL REVENUE SERVICE RULING. FOR EXAMPLE, SERVICE MEMBERS ASSIGNED TO GOVERNMENT QUARTERS OR LEASED HOUSING WOULD NOT EXPERIENCE A CORRESPONDING PAY REDUCTION. THUS, THE "LUCK OF THE DRAW" IN ASSIGNMENTS WOULD HAVE AN EVEN GREATER IMPACT ON QUALITY OF LIFE THAN ALREADY EXISTS. SERVICE MEMBERS ARE ALREADY SUBJECT TO INVOLUNTARY REASSIGNMENTS WITHOUT EMPLOYER PAYMENT OF HOME PURCHASING OR SELLING COSTS. THEIR FINANCIAL SITUATION WOULD BE EXACERBATED BY THE RULING. ADDING THESE IMPACTS TO THE ALREADY EXTRAORDINARY DEMANDS SERVICE LIFE IMPOSES ON MILITARY

FAMILIES COULD VERY WELL BE THE PROVERBIAL "STRAW" THAT BROKE THE CAMELS BACK, LEADING TO ANOTHER "HEMORRHAGE OF TALENT" WITH EVEN MORE DEBILITATING EFFECTS THAN WAS EXPERIENCED BY ALL OF THE SERVICES IN FY 1978 AND 1979. THE SIGNIFICANT DIFFERENCE TODAY IS THAT THE SERVICES NO LONGER HAVE THE "SAFETY NET" OF HIGHLY QUALIFIED AND EXPERIENCED NCOS AND OFFICERS STILL AVAILABLE FROM THE VIETNAM DRAW DOWN TO FILL IN THE GAPS.

THE IRS RULING WOULD CONSTITUTE A MAJOR CHANGE TO MILITARY COMPENSATION. THE TAX EXEMPT STATUS OF MILITARY ALLOWANCES WAS ESTABLISHED BY LEGISLATIVE ACTION, AFFIRMED BY A SUPREME COURT DECISION (JONES V. U.S.) IN 1925 AND HAS BEEN SUPPORTED BY CONGRESS EVER SINCE.

IN FACT, CONGRESS USES TAX ADVANTAGE TO COMPUTE LEVELS OF MILITARY PAY AND HAS INCLUDED THE TAX ADVANTAGE ASSOCIATED WITH TAX-FREE ALLOWANCES IN THE LAW WHICH DEFINES REGULAR MILITARY COMPENSATION (SECTION 101(25) OF TITLE 37 UNITED STATES CODE.)

THE PROPOSED IRS RULING IS A VERY BAD DECISION FROM A BUDGET STANDPOINT. THE TREASURY DEPARTMENT COULD COLLECT ABOUT $300 MILLION PER YEAR IN INCREASED TAXES. ALTHOUGH IT WOULD BE POSSIBLE TO CONSTRUCT NEW FAMILY HOUSING OR TO RAISE COMPENSATION LEVELS TO AMELIORATE THIS IMPACTS ON MILITARY PEOPLE NEITHER IS A VIABLE OPTION. NEW HOUSING CONSTRUCTION WOULD BE INORDINATELY EXPENSIVE AND MORE THAN LIKELY BE PRECLUDED BY THE FISCAL CONSTRAINTS IMPOSED BY THE BALANCED BUDGET AND EMERGENCY DEFICIT CONTROL ACT OF 1985 (PL 99-177).

THE ALTERNATIVE OF RAISING COMPENSATION ALSO PRESENTS EQUALLY

COMPELLING FISCAL REASONS FOR NOT PURSUING IT. TO OFFSET THE ADVERSE RETENTION IMPACTS, THE DEFENSE DEPARTMENT WOULD HAVE TO SPEND ANYWHERE FROM $1.1 BILLION TO $3 BILLION DEPENDING ON WHETHER A TARGETED OR ACROSS-THE-BOARD RAISE WAS CONSIDERED NECESSARY. NEITHER ALTERNATIVE WOULD BE A PRUDENT EXPENDITURE OF APPROPRIATED FUNDS GIVEN THE EXTRAORDINARY ACTIONS BEING TAKEN TO ELIMINATE THE BUDGET DEFICIT.

ON TWO OCCASIONS THE SENATE HAS ACTED TO PROHIBIT IRS FROM IMPLEMENTING ITS RULING. FIRST, THE SENATE VERSION OF THE FY 1985 DEFENSE AUTHORIZATION BILL CONTAINED AN AMENDMENT SPONSORED BY SENATOR JOHN WARNER (R-VA) PERMANENTLY BLOCKING IRS 83-3. HOWEVER, IT WAS DELETED IN CONFERENCE WITH THE HOUSE BASED ON A POTENTIAL JURISDICTIONAL DISPUTE WITH THE HOUSE WAYS AND MEANS COMMITTEE, THE OVERSIGHT COMMITTEE FOR TAX ISSUES.

LATER, SENATOR WILLIAM ARMSTRONG (R-COLO.) SUCCESSFULLY SPONSORED A "SENSE OF THE SENATE" RESOLUTION OPPOSING IMPLEMENTATION OF THE RULING. BASED PRIMARILY ON THIS ACTION, THE TREASURY DEPARTMENT AGREED NOT TO IMPOSE THE RULING AT LEAST UNTIL FEDERAL INCOME TAX RETURNS FOR 1987 ARE FILED.

DURING THE 99TH CONGRESS, TWO FAVORABLE DEVELOPMENTS OCCURRED WHICH MILITATE FOR FAVORABLE ACTION BY THE SENATE:

- THE JURISDICTIONAL PROBLEM, WHICH EXISTED IN PREVIOUS YEARS, IS OBVIATED BECAUSE THE HOUSE WAYS AND MEANS COMMITTEE, HAS INCLUDED THE NECESSARY LANGUAGE IN THE TAX REFORM ACT OF 1985; AND,

- THE DEFENSE DEPARTMENT RECEIVED CLEARANCE FROM THE OFFICE OF MANAGEMENT AND BUDGET AND ON OCTOBER 21, 1985 RENDERED A REPORT SUPPORTING ENACTMENT OF S.1595. THAT BILL WOULD ACCOMPLISH THE SAME OBJECTIVES AS SECTION 144 OF HR 3838 AND IS DESIGNED TO "PREVENT THE IMPLEMENTATION OF REVENUE RULING 83-3."

IN CONCLUSION, WE STRONGLY RECOMMEND THAT THIS COMMITTEE FAVORABLY CONSIDER SECTION 144 OF HR 3838 AS PASSED BY THE HOUSE AND THUS PRESERVE THE STATUS QUO. THE EXISTING TAX TREATMENT OF MILITARY HOUSING ALLOWANCES HAS SERVED SERVICE-MEMBERS AND THE NATION EXTREMELY WELL FOR DECADES. A CHANGE WOULD BE CLEARLY DISADVANTAGEOUS FROM AT LEAST THREE PERSPECTIVES: MORALE, NATIONAL SECURITY AND BUDGETARY IMPACT.

R

Roto Hammer Company

February 6, 1986

Attn: Betty Scott-Boom
The Honorable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Bldg.
Washington, D.C. 20510

Dear Senator Packwood:

The House-passed version of tax reform is anti-growth and anti-jobs. I urge the Senate to set aside reform for now, and turn its attention to the nation's twin-deficits -- spending and trade.

Sincerely,

ROTO HAMMER COMPANY, INC

Max L. Cardwell

Max L. Cardwell
President

MLC/kb

cc: Senator David Boren
Senator Donald Nickles

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~~Mary Frances Pearson~~

from ~~Pat McCleary~~

SUBMIT FOR RECORD

DRAFT

KEITH J. RUDOLF

Statement Submitted to the Senate Finance Committee
regarding
Taxation of United States Shareholders
in
Foreign Investment Companies

February 1986

My name is Keith Rudolf. I am a partner in the firm of Stein Roe & Farnham, which is one of the leading investment advisory firms in the nation, headquartered in Chicago. Our firm manages portfolios of U.S. stocks and bonds which total more than $10 billion for a wide variety of individual and institutional investors, virtually all of whom are U.S. persons.

Joint Venture -- Foreign Investment Company

Stein Roe has recently formed, after several years of preparatory work, a joint venture with a London-based investment firm, a private Swiss bank, and a major Japanese bank. This joint venture, of which I am a managing director, was formed for the purpose of sponsoring and managing a foreign investment company of just the sort which would be adversely affected by the enactment of the change in treatment of foreign investment companies contained in section 625 of H.R. 3838.

The House Provision Would Kill the Venture -- It Came As A Great Surprise

The change proposed in the House bill will make it difficult, if not impossible, for our joint venture to succeed. And this proposed change came without warning; it was not in the Treasury's proposals for tax reform, nor in the President's. No testimony was heard by the Ways & Means Committee on this topic. It was not until the Ways & Means Committee went into closed session in late September that the proposed change appeared. Thus, after years of planning, hard work, and the expenditure of substantial sums, we discovered that what we had thought would be a sound business venture was suddenly and critically threatened--and without any opportunity for comment or discussion with our elected representatives.

The Joint Venture Will Enhance American Competitiveness Abroad and Stimulate U.S. Economic Growth -- Therefore, the Senate Finance Committee Should Not Include Any Provision Dealing With Foreign Investment Companies In Its Bill

It is our firm conviction at Stein Roe that our proposed foreign investment company--if not prohibited by some change such as that in the House bill--will enhance American competitiveness in the world economy and will promote our nation's economic growth. Therefore, we are submitting this statement in the hope and expectation that this Committee will wisely decide not to include any provision dealing with foreign investment companies in its version of a tax reform bill. We trust that this Committee will conclude that tax reform does not consist merely of making changes in the Internal Revenue Code which, in the abstract (and without study or consideration), may satisfy someone's esoteric concept of "tax correctness." Rather, we hope that this Committee will look at this proposal in the context of the real world of competitive international markets as they exist today.

At a time when American efforts to expand effectively into international markets on a competitive basis should be assisted and encouraged, especially in areas where we have the prospect of capturing new markets, the proposed treatment of foreign investment companies contained in the House bill will have just the opposite effect--it will seriously impede those efforts, if it does not stop them dead in their tracks. Therefore, we earnestly urge this Committee to leave untouched the present law relating to foreign investment companies.

The Proposed Joint Venture Is A Good Case Study of the Specific Harm Which the House Provision Would Cause

Let me be more specific. Our firm, and the joint venture in which we are a participant, provide an excellent "case study" of the negative effects which would flow from the enactment of the proposed change in taxation of foreign investment companies--and by extension, the negative effects which enactment would have on the cost of capital to U.S. businesses, and the efforts of U.S. investment firms to expand their services abroad.

For all of its more than fifty years in business, Stein Roe has been an exclusively domestic firm--dealing only with U.S. investors, and investing the assets which those clients have placed under our supervision almost exclusively in U.S. securities.

However, with the rapidly increasing "internationalization" of financial markets over the past few years, interest by foreign investors in owning U.S. securities has increased dramatically, as has interest by U.S. investors in participating in foreign securities markets. The benefits to investors of international diversification of their portfolios has been well documented in academic literature and in actual experience.

The benefit to our nation's economy from the influx of foreign investment capital to our stock and bond markets, reducing the cost of capital to domestic firms, has also been widely publicized. Interestingly, the Staff of the Joint Committee on Taxation has concluded that H.R. 3838 will probably reduce foreign investment in U.S. corporate assets. But such investment helps to reduce interest rates, and that promotes expansion of domestic business and job creation. Prominent economists testifying before this Committee at these very hearings have forcefully confirmed these conclusions. Further, a reduction of interest rates would help reduce our balance of payments deficit by reducing interest payments to foreigners on our large external debt. This, in turn, would help reduce the value of the dollar with respect to other currencies, which is vital to promoting U.S. exports. Finally, the entry into foreign markets of U.S. financial services providers such as Stein Roe creates an export of U.S. services which, itself, helps reduce the balance of payments deficit. Does it make sense even to consider, in the name of "tax reform," changes in the Code which, at this time in our nation's struggle with foreign economic competition, serve to shackle our industry?

To ask the question is to answer it. It is patently clear that, in this increasingly international market for investments and investment services, American firms such as Stein Roe must expand their horizons if they are to continue to grow and prosper. But in the investment business, as in any other service which is built on specialized expertise, trust, confidence and reputation, expanding into a new market is not so simple a matter as opening a new office in a new location and waiting for the customers to present themselves.

For an American firm to attempt to develop by itself an expertise in foreign securities markets is a difficult task --one which our firm once attempted but quickly abandoned several years ago. Likewise, attracting foreign clients to invest in U.S. securities, without having an established reputation in foreign financial circles, is also a difficult task.

Our creation of a joint venture with several foreign investment institutions is an attempt to overcome those difficulties--giving our domestic firm an international exposure and an international investment capability, at a much lower cost and with lower business risk than if we were to attempt to expand directly and alone into foreign markets. Under present United States tax law, this undertaking is entirely consonant with the laws and practices of the United Kingdom, Switzerland, and Japan--the home countries of our joint venture partners. These countries consider it wise policy not to penalize their residents who expand into international markets.

What our firm brings to the joint venture, aside from its investment expertise in U.S. securities markets, is its base of U.S. investor-clients--and it is that base of clients which most interests our foreign partners. Enactment of the foreign investment company provisions of the

Code proposed in section 625 of H.R. 3838 would eliminate the possibility of attracting any such U.S. investors. Consequently, new investment of this type in the United States would dry up.

In short, the proposed change in the taxation of foreign investment companies would make it impossible for us to induce any U.S. investor to purchase shares in the company we have created--since the proposal would actually place such investments at a tax disadvantage in comparison with other investment alternatives, both domestic and foreign. Not only would U.S. investors in foreign investment companies be taxed on income they haven't received, but they would also be denied the capital gains treatment accorded investors in a domestic regulated investment company on capital gains earned by the company's investments.

If Stein Roe is unable to deliver U.S. investors to the joint venture, the future of the venture and the future of our effort to expand our firm's services internationally would be effectively frustrated.

The Tax Theory Underlying the House Bill Provision Relating to Foreign Investment Companies is Defective -- It Violates the "Ability To Pay" Principle

To the extent that it is at all germane to consider at this time* the technical rationale for the proposed changes in the House bill, we believe the tax theory which underlies the proposal is defective in that it violates a long-standing principle of federal income taxation--the "ability to pay" principle--by requiring the investor to pay a tax on income which he has not received. Exceptions to that principle have appropriately been made in those situations (for example, foreign personal holding companies) where it is clear that the shareholder is utilizing the corporation to defer taxation of income which is in fact within his control. However, the current proposal would extend such taxation to the investor in a majority foreign-owned investment company--a situation where not only has the investor not received any income on which he should be taxed, but also does not have sufficient control, even acting in concert with other U.S. investors, to compel the payment to him of a dividend. Such an extension of the doctrine of

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* We repeat, the economic health of Americans competing in foreign markets is much more vital to the Nation's welfare at this time than is a nicety in tax reform--even if the House bill provision were conceptually well-founded.

"constructive receipt" is both surprising and troubling (if not actually unconstitutional).

Proposed Changes Raise Difficult Administrative Problems Which May Make It Unworkable

In many cases the proposed changes would be very difficult to administer, as the investor would need to be able to compute his proportionate share each year of the earnings and profits of the foreign investment company. In many situations, the information necessary to do so may be altogether unavailable or, if available, presented on a basis insufficient to satisfy Internal Revenue Service rules.

Conclusion -- The Finance Committee Should Not Change the Present Law Relating to Foreign Investment Companies

The foregoing discussion merely suggests some of the difficult problems created by the new foreign investment company provision contained in section 625 of the House bill. A complex issue such as this deserves extensive hearings, thoughtful analysis, and then careful drafting to avoid unfairness and damage to American competitiveness abroad. None of this has been done.

In summary, we believe the House bill's provision (1) is ill-conceived from a tax theory and administration standpoint, (2) would have a very negative impact on U.S. investment firms such as ours in their efforts to export their services, and (3) would also have a negative influence on the importation of foreign investors' capital to U.S. securities markets.

Accordingly, we respectfully and earnestly submit that section 625 of the House bill should not be included in any tax reform legislation recommended by this Committee.

S

ST. OLAF COLLEGE

NORTHFIELD, MINNESOTA 55057
OFFICE OF THE PRESIDENT
(507) 663-3000

February 18, 1986

Dear Member of the Senate Finance Committee:

As an administrator of a non-profit educational institution, I am alarmed by several key provisions of H.R. 3838 (The Tax Reform Act 1985) recently passed by the U.S. House of Representatives and being considered by the U.S. Senate.

While I support the concept of tax reform, some of the bill's provisions concerning the pension plans of non-profit institutions would have a detrimental impact on thousands of such institutions throughout the country, including St. Olaf College. Many staff members depend on the system of fully funded and immediately vested retirement benefits provided by the Teachers Insurance and Annuity Association - College Retirement Equities Fund (TIAA-CREF). That organization is a pooling of pension funds for these staff members. TIAA-CREF has provided such benefits to educational, research and other non-profit organizations for more than 65 years. The benefit plans for these institutions will be severly disrupted if the Senate does not change key features of the bill regarding TIAA-CREF.

The first provision of H.R. 3838 I'm concerned about is Section 1012, which penalizes educational institutions through taxation of pension funds held by TIAA-CREF. Taxing TIAA-CREF plans alone, and not those of for-profit corporations, unions and governments not only would be highly discriminatory, it would be a direct contradiction of long-standing public policy, which has traditionally supported the nontaxability of employer-sponsored pension plans.

Section 1102 of the House bill would also impose a new lower limit of $7,000 on employee salary reduction contributions to retirement and tax-deferred annuity plans. The new limit severly restricts an individual's ability to save additional amounts for retirement. I ask that this provision be amended so that required employee retirement plan contributions made via salary reduction are not included in the $7,000 limit.

Section 1101 reduces an individual's maximum $2,000 contribution to an Individual Retirement Account by one dollar for each dollar contributed on a salary reduction basis to a 403(b) annuity. In practice, this provision would effectively eliminate the use of an IRA because individuals who make any IRA contributions would be limited to a combined maximum IRA and salary reduction contribution of $2,000. This could even hamper participation in an employer's retirement plan.

Section 1123 of the bill requires that a 15% penalty tax be assessed against withdrawals from tax-deferred annuity accumulations resulting from contributions made before December 31, 1985, unless the individual making the withdrawals is over age 59½, becomes disabled, or dies. One of the most unfortunate consequences of the 15% tax penalty is that it acts as a regressive tax on employees in lower tax brackets. These employees would lose a proportionately higher share of their funds, should they have to pay this penalty tax, than would an individual in a higher tax bracket, since the higher tax bracket individuals receive a greater percentage rate decreases under the tax reform bill than do those in lower brackets.

H.R. 3838 would also impose severe administrative burdens. I refer specifically to Section 1113 of the bill, requiring pension plans of certain non-profit employers to periodically satisfy nondiscrimination requirements. The imposition of plan design and participation rules on the pension plans of non-profit organizations, would require additional expenditures for legal and actuarial counsel, for internal administration, and possibly for plan design changes in order to demonstrate compliance with the rules on a periodic basis. Institutions would be burdened with this added cost even though there is no evidence that any significant problem of pension discrimination against lower paid employees exists, either with respect to coverage or level of benefits.

Accordingly, I do not believe that the U.S. Senate should enact these provisions of H.R. 3838 because of their significant detrimental impact on the pension plans and tax-deferred annuity arrangements used by the educational community. I urge you to correct these flaws in the bill before it reaches a vote, or to remove the entire pension topic from the Tax Reform Act and consider it at a later time.

Thank you for your consideration of these important issues.

Sincerely yours,

Mel D. George

Melvin D. George
President

MDG:ss

Statement of

Phillip C. England

Vice President, Tax

Sea-Land Corporation

To The

United States Senate

Committee on Finance

Discussing

Tax Reform and the

United States Shipping Industry

February 14, 1986

On behalf of Sea-Land Corporation ("Sea-Land"), I would like to thank the Committee for the opportunity to comment on the importance of tax policy to the international competitiveness of the United States shipping industry.

Sea-Land is a major United States container transportation and trade service company. We use 61 container ships of both U.S. and foreign registry and over 100,000 containers to form a worldwide network of assets serving 76 ports in 64 countries and territories around the world.

Tax Policy For U. S. Shipping

As the Committee returns to its consideration of tax reform, I would begin my comments by reiterating a concern expressed in my testimony last autumn; that is, whether Congress is willing to maintain a tax environment that will allow U. S. shipping companies to remain competitive in international commerce? Failure to adequately consider the international competitive ramifications of our tax system could result in the further shrinking of the U. S.-flag and U. S. controlled foreign-flag fleets, the loss of U. S. maritime jobs, and higher freight payments to foreign-owned shipping companies by American importers and exporters.

The key to the ability of U. S. shipping companies to compete in international commerce is cost competitiveness. In the highly competitive international shipping business, this means that U. S. owned companies in head-to-head competition with foreign operators must achieve cost competitiveness in every phase of operation, including tax costs. This is especially true today with the shipping industry in the throes of a worldwide depression as a result of severe overcapacity. In comparing the United States' system of maritime aids with those of competing seafaring nations it should be remembered that the mix of supports provided by each nation differs, combining direct subsidies and other aids with tax incentives in varying degrees.

Therefore, it is not always possible to make direct comparisons of the tax systems of competing seafaring nations.[1]

Ocean shipping is among the most capital intensive businesses in the world. The three issues of greatest concern to Sea-Land, therefore, all affect the cost of capital. Those issues are as follows: (1) proposed changes in the capital recovery provisions, i.e., the proposal to repeal the investment tax credit (ITC) and to increase the number of years over which the cost of vessels and other property may be recovered for tax purposes; (2) to repeal the shipping reinvestment provisions of Subpart F of the Internal Revenue Code; and (3) to change the rules affecting the Capital Construction Fund. My testimony will concentrate on these issues.

Capital Cost Recovery Provisions

[illegible] House tax reform bill, H.R. 3838, would replace the [illegible]celerated Cost Recovery System ("ACRS") with the Incentive [illegible]preciation System ("IDS"). Under IDS, assets would be grouped [illegible]o ten classes based on class lives assigned under the Asset Depreciation Range ("ADR") system, which preceded ACRS. Under

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[1] Attachment I contains materials from Maritime Subsidies, prepared by the U. S. Department of Transportation, Maritime Administration, in 1983. It summarizes tax and other maritime aids available in Japan, Taiwan, Germany, the United Kingdom, Singapore and Hong Kong. It has been updated by Sea-Land.

IDS, vessels are assigned to Class 6, with the cost of a vessel recoverable over a sixteen year period. If inflation exceeds five percent, an inflation adjustment would be made in the asset's undepreciated basis to reflect one-half the inflation rate in excess of five percent. This compares with the current five year recovery period under ACRS, further improved by the effect of ITC.

Even considering the proposed reduction in the corporate tax rate from 46 percent under current law to 36 percent under H.R. 3838, this proposal would increase the taxes applicable to U. S. shipping companies, which would result in a commensurate rise in their cost of capital while generating an insignificant amount of revenue for the U.S. Treasury. The critical question, however, is how IDS compares with the capital cost recovery systems applicable to foreign competitors of U. S. shipping companies in international commerce. Based on information provided by the Maritime Administration, U. K. and West German law provide that the cost of vessels may be recovered under a 25 percent declining balance method.[2] Under this system, the first year capital recovery allowance is 25 percent of cost, with subsequent years allowances being based on 25 percent of the declining balance of unrecovered cost. West German law also allows taxpayers to elect to recover 40 percent of the cost of a vessel in the first year, with the remainder recoverable over 12 to 14 years on a straight-line basis.[3] In Hong Kong, owners of vessels may recover 55 percent of the cost of a vessel in the first year, with the remainder recoverable on a 10 percent declining balance method.

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[2] Id.

Based on our calculations, over the first five years of ownership vessel owners in the U. K., West Germany, and Hong Kong can deduct approximately 150 percent in capital recovery deductions of the amount that U. S. owners could deduct under IDS Class 6 (Attachment II - Sample Capital Recovery Calculation). To allow U. S. shipping companies to remain competitive with foreign companies would require that vessels used in international commerce be placed in IDS Class 3. In Class 3 asset costs are recovered over a seven year life. If vessels used in international commerce are not placed in IDS Class 3, U. S.

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[3] Other examples are contained in Attachment I, Maritime Subsidies.

shipping companies will have a significantly higher cost of capital than foreign companies with which they compete.[4] As discussed more fully below, most foreign flag vessels operate in a nearly tax free environment.

Subpart F Shipping Reinvestment Provision

Prior to enactment of the Tax Reduction Act of 1975, the income of foreign shipping subsidiaries of U. S. companies was taxed similarly to other foreign subsidiaries of U. S. corporations, i.e., U. S. taxation was deferred until earnings were repatriated unless such earnings were derived from dealings with affiliated companies. However, the 1975 Act changed the rule for shipping companies by providing for immediate U. S. taxation of unremitted earnings unless they were reinvested in shipping assets. In this regard U. S. shipping companies have been treated more harshly than other types of U. S. business which generally have the ability to avail themselves of the economies of foreign operations, including lower labor costs, and defer current U. S. taxation.[5] H.R. 3838 would go even further and repeal the shipping reinvestment deferral. This would be particularly detrimental to the competitiveness of U.S. owned foreign-flag feederships operating in a foreign-to-foreign environment in direct competition with foreign owned foreign-flag vessels whose operations are not taxed by any government.

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[4] As noted earlier, the capital cost recovery rules in many countries are not directly comparable with those of the United States, the U. K. and Hong Kong. Some governments choose to promote the shipping industry through direct government subsidies (e.g., Attachment I, at iii), while others exempt income earned outside the home country from taxation, as in the case of Singapore, Panama and Liberia.

[5] U.S. flag carriers are required by law to employ U.S. citizens to man their vessels, and to comply with generally more stringent safety standards than their foreign competitors.

While expanding the definition of subpart F income to include shipping income in the 1975 Act, Congress recognized that U. S. shipping companies could not compete if they had to pay for their vessels in after-tax earnings while their competitors could operate essentially tax free. In attempting to balance the equities, the report of the House Committee of Ways and Means in 1975 stated as follows:

> However, your committee recognizes that the competitive nature of shipping operations makes it difficult to impose taxes on the profits of the foreign flag fleets of U. S. persons so long as the foreign flag fleets of other nations are not subject to any significant taxes. The interests of the United States are best served if we have a significant U. S.-owned maritime fleet. To assume and maintain this status, large amounts of capital are necessary. . . Your committee's bill, therefore, provides that the income of foreign corporations controlled by U. S. shareholders will be currently taxed, but only to the extent that it is not reinvested in qualified shipping assets.[6]

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[6] Report of the House Committee on Ways and Means on H.R. 17488, Energy Tax and Individual Relief Bill of 1974, No. 93-1502, 93rd Cong. 2d Sess. pp. 135-139.

The conclusion drawn by the Committee, essentially that the U. S. owned foreign-flag fleet cannot compete if its earnings are subject to immediate U. S. taxation while the earnings of it's foreign owned competition is not, is just as valid today as it was ten years ago. If the national defense and economic interests of the United States are still best served by having a significant U. S. owned maritime fleet, then repeal of the subpart F shipping reinvestment provision clearly does not serve U. S. interests.

Sea-Land's fleet contains both U.S.-flag and foreign-flag containerships. The foreign-flag vessels are used primarily in foreign-to-foreign feeder operations, which collect cargo from smaller ports and transport it to major foreign ports served by Sea-Land's large U. S.-flag vessels. The foreign-to-foreign environment in which the foreign feeder vessels operate is economically closed to U. S.-flag vessels as a result of their higher labor and capital costs. The ability of U.S. carriers to compete in this foreign-to-foreign environment with foreign-flag feederships directly contributes to the strength and competitiveness of the U.S.-flag fleet in U.S. foreign commerce. The repeal of tax deferral through subpart F reinvestment would clearly weaken Sea-Land's and other U. S. container shipping companies' ability to compete against foreign owned competitors. In the end, therefore, subpart F reinvestment in containerships in foreign-to-foreign commerce results in more jobs for U. S. seamen in U.S. foreign commerce.

Based on the points made above, and the fact that repeal likely would result in little or no additional revenue to the Treasury, especially in the current economic climate for shipping, Sea-Land strongly opposes repeal of the subpart F reinvestment provision.

The Capital Construction Fund Program

One of the cornerstones of U. S. maritime policy is the Capital Construction Fund provision of Section 607 of the Merchant Marine Act of 1936, as amended ("CCF"). Under this program, taxpayers are allowed to defer taxation on deposits into a CCF. When funds are withdrawn to purchase or construct a vessel or related asset in the U.S., the taxpayer's basis in the asset is reduced, thereby reducing depreciation deductions that would otherwise have been available if CCF funds had not been used to finance the acquisition.

The CCF program is one of tax deferral, not tax exemption as intimated in the President's Tax Proposal, which called for the repeal of the CCF program. Therefore, the amount of taxes payable by taxpayers utilizing a CCF for vessel construction is the same over time, with or without the CCF program. The difference is that with a CCF, capital for assets essential to operations may be more rapidly accumulated, i.e., on a tax deferred basis.

The CCF program also provides U.S. maritime jobs. Sea-Land is currently using the program to build three containerships at Bay Shipbuilding Corporation in Wisconsin costing $190 million. This contract alone is directly responsible for the employment of hundreds of people in the shipyard and in plants of material suppliers in a number of states.

H.R. 3838 would retain the CCF program but would add certain restrictions. These restrictions include a ten-year limit on use of deposits and additional penalties for nonqualified withdrawals. H.R. 3838 would also codify the CCF provisions in the Internal Revenue Code and require that the Secretaries of Transportation and Commerce certify to the Secretary of the Treasury that monies in CCFs are appropriate for vessel construction requirements of fundholders.

In our view, these additional requirements are unnecessary and redundant. For instance, the ten-year time limit on using funds may be too short. This is best illustrated by the present circumstances of the shipping industry with overcapacity of nearly every class of vessel in every trade. While this condition may last several years, it in no way invalidates the eventual need to build new vessels. It may, however, affect the timing of their construction. Therefore, at minimum, flexibility should be added in this area.

In view of the success of the CCF program and the minimal cost to the Treasury of maintaining current rules (estimated at approximately $5 million annually), we urge that current law be retained unchanged. If current law is to be changed, we urge that such changes not be retroactive in effect nor be predjudicial to the taxpayers who have supported this program in the past, and we believe the legislation which terminated Domestic International Sales Corporations was fair in this regard.

Other Issues

Highlighted below are other issues of concern to Sea-Land.

- Transition Rules and Effective Dates

  As with other businesses, Sea-Land is severely handicapped in making business decisions by the lack of a clear effective date for the tax legislation currently being considered. This lack of certainty is immobilizing. We advocate, therefore, that the House and Senate agree now on January 1, 1987 as the effective date for any tax legislation that may be passed.

We further advocate that this agreement make clear the transition rules and dates that will apply. We believe that the type of transition rules contained in H.R. 3838 are fair, but "placed in service" dates should be adjusted to reflect the new overall effective date for the legislation of January 1, 1987.

- Source Rules For Transportation Income

H.R. 3838 would deem that 50 percent of a vessel's revenues from a voyage are attributable to U. S. sources where one port is a U. S. port and the other is a foreign port. This is a significant departure from international norms reflected in current U. S. rules, i.e., source now being determined based on the time a vessel actually spends in U. S. waters as a fraction of the entire voyage. This proposal invites retaliation from the very countries it is aimed at influencing, a small number of developing countries in Asia that currently impose gross receipts tax. Since only a small number of vessels owned by residents of these countries call in U. S. ports, the U. S. would gain little leverage over them by adopting such a rule. We, therefore, support current rules for sourcing transportation income.

- Reciprocal Exemption

H.R. 3838 proposes that for foreign corporations earning U.S. source shipping income the reciprocal exemption from U. S. tax contained in section 883 of the Code be based upon the residence of the ultimate shareholders of the entity, rather than the longstanding practice of looking to the country of a vessel's registry. If the shareholder does not meet the reciprocal exemption test because his country of residence does not have a reciprocal exemption with the U. S., then 50 percent of a vessel's revenues from a voyage to a U. S. port would be subject to a four percent gross receipts tax. Under the bill the tax is imposed on U. S. source income of foreign persons derived from the use or hiring (or leasing for use) of any vessel, and is to be withheld by the person, U. S. or foreign, that controls the payment of income to the foreign person.

We believe that, practically speaking, this rule could not be administered. Even in the most straightforward vessel chartering situation the identity of the ultimate owners of the corporation owning the vessel may not be known. Often two or more levels of charter are involved with respect to a single vessel, with the identity of the ultimate owners of the corporations which own and charter the vessels shielded by several tiers of corporations. Therefore, we support maintaining the current rules which refer to a vessels' country of registry for purposes of determining the application of the reciprocal exemption.

Conclusion

As stated earlier, the key to the ability of U. S. shipping companies to compete in international commerce is cost competitiveness. For capital intensive U. S. shipping companies this means maintaining a tax environment that allows U. S. companies to compete with foreign competitors. We believe that the adoption of the positions advocated by Sea-Land would provide U.S. shipping companies with a competitive tax environment, and respectfully urge that your committee adopt them.

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ATTACHMENT 1

MARITIME INCENTIVES

I. UNITED KINGDOM

Tax Incentives

- Capital Recovery:
  - First year allowance - Currently 50 percent. (Being reduced gradually and to be phased out for expenditures incurred after April 1, 1986).
  - Annual capital recovery allowance - 25 percent per year calculated on a declining balance basis over a four year life.
  - Shipping companies generally exempt from anti-avoidance of tax provision.
  - Capital gains tax deferred if proceeds of sale of vessels is reinvested in new assets to be used in the same business within specified time limits.
  - Special benefits under value added tax.

Other Incentives

- Government guarantees of principal and interest on loans for new vessels constructed in the U.K.
- Grants to British shipbuilders of up to 20 percent of the contract price of a vessel.
- Regional incentives in areas of high unemployment.

II. WEST GERMANY

Tax Incentives

- Capital Recovery allowances:
  - First year allowance - 40 percent.
  - Annual capital recovery allowance - 25 percent per year on a declining balance method over a 12-14 year life, or on a straight-line basis over the same period (note only straight-line depreciation is available if special first year allowance utilized).
  - Tax on profit from the sale of vessels may be deferred if reinvested within two years in either a new vessel or major conversion of an existing vessel. Basis is reduced in the new vessel by the amount of tax deferred profit.
  - Seagoing vessels are exempt from value added tax.

Other Incentives

- Ship construction subsidies may be granted to German owners ordering vessels in German or foreign shipyards. Subsidies have been as high as 12.5 percent of vessel cost.
- Credit guarantees are available from certain coastal states for new commercial vessels built in local yards, provided certain criteria are met.
- Interest subsidies for the purchase of vessels.

III. JAPAN

Tax Incentives

- Tax free reserve fund for replacement of ships and shipbuilding equipment.
- Special depreciation reserve - In addition to ordinary depreciation a shipping company may claim additional depreciation of 15 percent of cost for ocean-going vessels that contribute to the efficiency of the Japanese merchant marine fleet.
- Special repair reserve - A deductible reserve for vessel repair may be created.
- Tax on capital gain from the sale of vessels may be deferred if proceeds are reinvested in new vessels.

Other Incentives

- Scrap and build subsidy program - intended to replace uneconomical ocean-going vessels. Under this program Japan's Maritime Credit Corporation participates with vessel owners in the construction of new vessels in exchange for a fee. Overall the program results in a substantially reduced cost of construction.
- Japan Development Bank loans to Japanese shipowners on favorable terms.

IV. SINGAPORE

Tax Incentives

- Income from transportation services performed in international waters are exempt from taxation in Singapore.
- Gain on the sale of a Singapore registered vessel is not subject to tax, and is tax free in the hands of a shareholder upon distribution as a dividend.
- Dividends distributed out of other tax exempt shipping profits are also not taxable to the shareholder.

Other Incentives

- Government sponsored financing program. (We are advised that the rates available under the program are not competitive, and that the program is therefore not being utilized currently.)

V. HONG KONG

Tax Incentives

- Low tax rate of 18.5 percent.
- Exemption from tax on foreign source income if vessel does not trade with Hong Kong.
- Capital allowance of 55 percent in year one and 10 percentage per year of the remainder of the declining balance method.

Other Incentives

- None

VI. TAIWAN

Tax Incentives

- Low tax rate of 25 percent.
- Four year income tax exemption on income derived from vessels provided certain requirements are met. Alternatively accelerated depreciation may be taken on vessels.
- A tax credit of 15 percent for locally produced equipment and 5 percent for imported equipment.

Other Incentives

- Construction subsidies on Taiwan registered vessels constructed in local shipyards.
- Subsidized interest government loans.

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ATTACHMENT 2

Sample Capital Recovery Calculation
($000s)

	U.K.	HONG KONG	U.S. IDS Class 6	U.S. IDS Class 3
Original Cost	$100,000	$100,000	$100,000	$100,000
Rate of Capital Recovery	x 25%*	x 55%**	x 12.5%***	x 28.5%****
1st Year Deduction	$ 25,000	$ 55,000	$ 12,500	$ 28,500
Balance Year 2	$ 75,000	$ 45,000	$ 87,500	$ 71,500
Rate of Capital Recovery	x 25%	x 10%**	x 12.5%	x 28.5
2nd Year Deduction	$ 18,750	$ 4,500	$ 10,938	$ 20,377
Balance Year 3	$ 56,250	$ 40,500	$ 76,562	$ 51,123
Rate of Capital Recovery	x 25%	x 10%	x 12.5%	x 28.5%
3rd Year Deduction	$ 14,060	$ 4,050	$ 9,570	$ 14,570
Balance Year 4	$ 42,188	$ 36,450	$ 66,992	$ 36,553
Rate of Capital Recovery	x 25%	x 10%	x 12.5%	x 28.5%
4th Year Deduction	$ 10,550	$ 3,645	$ 8,374	$ 10,418
Balance Year 5	$ 31,640	$ 32,805	$ 58,618	$ 26,135
Rate of Capital Recovery	x 25%	x 10%	x 12.5%	- 3%
5th Year Deduction	$ 7,910	$ 3,280	$ 7,327	$ 8,712
Balance of Basis	$ 23,730	$ 29,524	$ 51,291	$ 17,423
Cumulative Deductions	$ 76,270	$ 70,476	$ 48,709	$ 82,577

* 25% Declining balance method.
** 55% first year allowance with balance subject to ten percent declining balance method.
*** Reflects double-declining balance method over 16 year life.
**** Reflects double-declining balance method over 10 years.

CJ-1231c:ch
1/29/86

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PHONE NO.
543-3211

SOUTHERN BRICK COMPANY
A COMPLETE LINE OF QUALITY CLAY PRODUCTS
NINETY SIX. S. C.
29666

February 7, 1986

ATT: Betty Scott-Boom
The Honerable Robert Packwood
Chairman, Senate Committee on Finance
219 Russell Senate Office Building
Washington, DC 20510

Dear Mr. Packwood:

Please let these comments be included in the hearing records on H.R. 3838.

Tax-reform is not needed at this time. It may be needed in the future when true reform is addressed. Gramm-Rudman-Hollings is very significant and should be allowed to work without the disruption of tax-reform. Correct the spending excesses, and the trade deficits and then work hard for true tax reform-NOT NOW.

Sincerely,

Joe H Patrick Jr

Joe H. Patrick, Jr., President
Southern Brick Company
P.O. Box 208
Ninety Six, SC 29666
803-543-3211

JHPjr/sw

CC: Senator Strom Thurmond
Senator Ernest Hollings

All agreements are contingent upon strikes, accidents, fires, or other causes of delay beyond our control. Quotations subject to change without notice.

STATEMENT OF THE SOUTHERN ELECTRIC SYSTEM
TO THE COMMITTEE ON FINANCE
February 7, 1986

The Southern Company is the parent company of four operating electric utility companies. The operating companies are Alabama Power Company, Georgia Power Company, Gulf Power Company and Mississippi Power Company. Together these four operating companies are informally referred to as the "Southern electric system" and, on a combined basis, serve over 2.9 million retail customers in a 120,000 square mile area consisting of the major portion of Georgia, central and southern Alabama, northwest Florida and southeast Mississippi. These four companies have a total generating capacity of 25,657 megawatts and currently have under construction a total of 4,900 megawatts of new capacity.

The Southern electric system supports the need to reform and simplify the tax laws to achieve equitable taxation. However, we do not believe that capital formation incentives are expendable items in this process. Capital formation incentives are a vital source of capital to the Southern electric system. In this regard, the Southern electric system is submitting this testimony in response to the Senate Finance Committee request for comments on the economic effects of the Tax Reform Act of 1985 (H.R. 3838) on capital formation.

Under H.R. 3838, internal cash flow to the Southern electric system would be reduced by about $2.7 billion by the year 1995, and $6.9 billion by the year 2000. The largest contributors to the reduction in cash flow are the repeal of the investment tax credit and the elimination of capital formation incentives under the new proposed tax depreciation system.

The Southern electric system is located in an area (Southeastern United States) that is part of the so-called "Sun Belt" which has been projected by many to have the greatest economic growth in the nation. In order to provide an adequate supply of electricity to the expanding economy of the Southeast, the Southern electric system has projected that it will require for the period, 1986-1995, about $4.0 billion of additional debt and equity capital in order to finance needed electrical facilities.1/ The loss of internal cash flow under H.R. 3838 would increase the requirement for additional debt and equity capital to about $6.7 billion, or a 67.5 percent increase. An increase of 67.5 percent in capital requirements, obviously, produces a tremendous impediment in meeting the future demand for electricty in the Southeastern United States and would increase the cost of electricity.

The Southern electric system is very concerned about the lack of any capital formation incentives in H.R. 3838. With respect to the proposed new incentive depreciation system under H.R. 3838, a disincentive is provided rather than an incentive for investment in electric utility property when the impacts of inflation are considered.

1/ While the Southern electric system is pursuing conservation, load management, solar technology, and cogeneration projects, it is apparent that, in the long run, these resources will not completely replace the need for larger central station power plants in order to meet the demand for electricity in the late 1990's.

A study by Emil Sunley, of Deloitte Haskins & Sells and former Deputy Assistant Secretary of the Treasury, demonstrates the severe attrition of depreciation incentives contained in H.R. 3838. He calculated the real effective tax rate on electric utility property resulting from H.R. 3838. The real effective tax rate under H.R. 3838, with 5 percent inflation, would approximate 49.7 percent for a fossil generating plant and, with 10 percent inflation, would approximate 59.5 percent. As the statutory corporate rate is 36 percent under H.R. 3838, the calculation clearly demonstrates the lack of capital formation incentives under H.R. 3838. Indeed, H.R. 3838 provides a disincentive to invest.

We urge the Senate Finance Committee to review carefully the vital need for capital formation incentives, and to adopt the proposed capital cost recovery system (CCRS) of tax depreciation which is included in the President's tax reform proposal. The Southern electric system supports the concept in CCRS which would give equal treatment relative to investment incentives for all assets for all industries. This concept is consistent with the theme in the President's proposal which is intended to create a "level playing field" for all investments for all taxpayers.

Although historically tax incentives for investment have been biased against public utility property, there is no economic or other reason that justifies excluding regulated industries from federal programs to stimulate investment. The tax law should not be used to make the capital cost of goods produced by a regulated firm arbitrarily higher than that of goods produced by an unregulated firm. To the extent that investment incentives continue to exist, the public utility industry should be granted complete and equal access to them.

To provide a neutral investment incentive in the CCRS tax depreciation system, the President's proposal sets depreciation rates and recovery periods to produce a real effective tax rate of 18 percent on the income from new investments in all types of machinery and equipment. The real effective tax rate on the income from new investment in utility property under CCRS would be about 22 - 24 percent. Although this is above the President's target rate of 18 percent, the difference or bias is much less than the bias that has existed in prior years. Moreover, the important point is that the President's proposed depreciation system provides capital formation incentives.

The repeal of the investment tax credit would be particularly detrimental to the Southern electric system. The credit has provided an important source of capital to help finance the construction of needed electric generation, transmission, and distribution facilities. The loss of the credit would require significant increases in external financing.

If the investment tax credit is repealed, we believe that reasonable and equitable transitional rules should be provided. The transitional rules for the repeal of the investment tax credit under H.R. 3838 are reasonable and equitable; therefore, we urge the Senate Finance Committee to adopt these transitional rules.

The Southern electric system is concerned with the method in H.R. 3838, for capitalizing construction-period interest. According to H.R. 3838, construction-period interest would be defined to include any interest expense of a taxpayer that could be avoided if construction expenditures were used to repay indebtedness. This incorrectly assumes that 100 percent of construction would be financed by means of borrowed funds. While this assumption may or may not be true with respect to nonregulated businesses, it can be stated without equivocation that this would not be true for regulated electric utilities.

The regulatory accounting rules of many jurisdictions already require full or partial capitalization of financing costs on projects involving significant construction periods or costs. These rules recognize that both debt and equity capital is required to finance construction. We urge that the tax rules recognize that debt and equity is required to finance construction projects. Thus, only a portion of a construction project would be subject to the capitalization rules. That is, only interest which is related to the portion of the construction project which is financed with debt would be capitalized.

One of the goals of tax reform is to provide a tax system which does not favor debt financing over equity financing. To partially achieve this goal, a deduction would be provided for 10 percent of dividends paid. However, this dividend deduction would be substantially nullified by the provisions of H.R. 3838 which require the capitalization of interest under the avoided cost concept. The avoided cost concept would, in effect, provide a significant penalty for financing construction expenditures with equity capital. This result is untenable in light of the stated goals of tax reform.

If the avoided cost concept is eventually enacted, the Southern electric system's internal cash flow for the period, 1986-2000, would be reduced by about $700 million and electricity costs to our customers would increase by about $500 million for the same period. This increase in electricity costs would substantially offset the favorable impact of the 10 percent dividend paid deduction. This contradiction should be corrected.

H.R. 3838 provides for a new alternative minimum tax for corporations. The Southern electric system's main concern relates to the tax rate of 25 percent. This rate is too high given the fact that the regular corporate income tax rate would be 36 percent under H.R. 3838. Because of the narrow difference between 36 percent and 25 percent, the alternative minimum tax could replace the regular corporate income tax system during times of financial stress for capital intensive industries like electric utilities. This result would substantially eliminate capital formation incentives (specifically accelerated tax depreciation) during times when such incentives are critically needed. We suggest that the alternative minimum tax rate be no higher than 15 or 20 percent in order to avoid the undesirable impact discussed above.

In summary, we urge the Senate Finance Committee to consider carefully the consequences of repealing any capital formation incentives. Specifically, we recommend that:

- the President's CCRS tax depreciation system be adopted;
- the transitional rules under H.R. 3838 relative to the repeal of the investment tax credit be adopted;

- the alternative minimum tax rate be no higher than 15 or 20 percent; and
- the avoided cost concept in H.R. 3838 relative to the capitalization of interest be corrected to recognize equity capital.

[illegible]
350 Spelman Lane SW • Atlanta, Georgia 30314-4399 • 404/681-3643

Dr. Donald M. Stewart
President

February 17, 1986

SENATE FINANCE COMMITTEE
Senate Committee on Finance
Room SD-219
Senate Dirksen Office Building
Washington, DC 20510

Dear Members of the Senate Finance Committee:

The faculty and staff at Spelman College support TIAA-CREF's tax-exempt retirement system and its continuation of the long-standing tax exemption for pension plan funds for educators. This program has been and still is a valuable and necessary retirement plan for personnel in institutions of higher education. Its continuation is vital to the retirement of both active and retired personnel all over the country.

We urge very strongly that you support its continuation.

Sincerely,

Donald M. Stewart

Donald M. Stewart
President

DMS r

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cc: Senator Sam Nunn
Senator Matt Mattingly
Congressman Wyche Fowler

STATEMENT OF KEITH J. RUDOLF

PARTNER, STEIN ROE & FARNHAM

**Regarding Proposed Changes in
Taxation of United States Shareholders
of
Foreign Investment Companies
(H.R. 3838, § 625)**

My name is Keith Rudolf. I am a partner in the firm of Stein Roe & Farnham, which is one of the leading investment advisory firms in the nation, headquartered in Chicago. Our firm manages portfolios of U.S. stocks and bonds which total more than $10 billion for a wide variety of individual and institutional investors, virtually all of whom are U.S. persons.

Joint Venture -- Foreign Investment Company

Stein Roe has recently formed, after several years of preparatory work, a joint venture with a London-based investment firm, a private Swiss bank, and a major Japanese bank. This joint venture, of which I am a managing director, was formed for the purpose of sponsoring and managing a foreign investment company of just the sort which would be adversely affected by the enactment of the change in treatment of foreign investment companies contained in section 625 of H.R. 3838.

The foreign investment company we are establishing will be at least 60 percent owned by foreign nationals, with the balance of the investors drawn from the United States. The foreign investment company will invest its assets in a diversified portfolio including stocks, securities, and commodities throughout the world. However, a significant portion of those investments will be made in the United States, thus drawing substantial additional foreign investment into this country. In addition, because Stein Roe will act as an investment advisor to the foreign investment company, we will be able to expand our financial services into foreign markets that we have heretofore been unable to penetrate.

The House Provision Would Kill the Venture -- It Came As A Great Surprise

The change proposed in the House bill will make it difficult, if not impossible, for our joint venture to succeed. And this proposed change came without warning; it was not in the Treasury's proposals for tax reform, nor in the President's. No testimony was heard by the Ways & Means Committee on this topic. It was not until the Ways & Means Committee went into closed session in late September that the proposed change appeared. Thus, after years of planning, hard work, and the expenditure of substantial sums, we discovered that what we had thought would be a sound business venture was suddenly and critically threatened--and without any opportunity for comment or discussion with our elected representatives.

The Joint Venture Will Enhance American Competitiveness Abroad and Stimulate U.S. Economic Growth -- Therefore, the Senate Finance Committee Should Not Include Any Provision Dealing With Foreign Investment Companies In Its Bill

It is our firm conviction at Stein Roe that our foreign investment company--if not prohibited by some change such as that in the House bill--will enhance American competitiveness in the world economy and will promote our nation's economic growth. Therefore, we are submitting this statement in the hope and expectation that this Committee will wisely decide not to include any provision dealing with foreign investment companies in its version of a tax reform bill. We trust that this Committee will conclude that tax reform does not consist merely of making changes in the Internal Revenue Code which, in the abstract (and without study or consideration), may satisfy someone's esoteric concept of "tax correctness." Rather, we hope that this Committee will look at this proposal in the context of the real world of competitive international markets as they exist today.

At a time when American efforts to expand effectively into international markets on a competitive basis should be assisted and encouraged, especially in areas where we have the prospect of capturing new markets, the proposed treatment of foreign investment companies contained in the House bill will have just the opposite effect--it will seriously impede those efforts, if it does not stop them dead in their tracks. Therefore, we earnestly urge this Committee to leave untouched the present law relating to foreign investment companies.

The Proposed Joint Venture Is A Good Case Study of the Specific Harm Which the House Provision Would Cause

Let me be more specific. Our firm, and the joint venture in which we are a participant, provide an excellent "case study" of the negative effects which would flow from the enactment of the proposed change in taxation of foreign investment companies--and by extension, the negative effects which enactment would have on the cost of capital to U.S. businesses, and the efforts of U.S. investment firms to expand their services abroad.

For all of its more than fifty years in business, Stein Roe has been an exclusively domestic firm--dealing only with U.S. investors, and investing the assets which those clients have placed under our supervision almost exclusively in U.S. securities.

However, with the rapidly increasing "internationalization" of financial markets over the past few years, interest by foreign investors in owning U.S. securities has increased dramatically, as has interest by U.S. investors in participating in foreign securities markets. The benefits to investors of international diversification of their portfolios has been well documented in academic literature and in actual experience.

The benefit to our nation's economy from the influx of foreign investment capital to our stock and bond markets, reducing the cost of capital to domestic firms, has also been widely publicized. Interestingly, the Staff of the Joint Committee on Taxation has concluded that H.R. 3838 will probably reduce foreign investment in U.S. corporate assets. But such investment helps to reduce interest rates, and that promotes expansion of domestic business and job creation. Prominent economists testifying before this Committee at these very hearings have forcefully confirmed these conclusions. Further, a reduction of interest rates would help reduce our balance of payments deficit by reducing interest payments to foreigners on our large external debt. This, in turn, would help reduce the value of the dollar with respect to other currencies, which is vital to promoting U.S. exports. Finally, the entry into foreign markets of U.S. financial services providers such as

Stein Roe creates an export of U.S. services which, itself, helps reduce the balance of payments deficit. Does it make sense even to consider, in the name of "tax reform," changes in the Code which, at this time in our nation's struggle with foreign economic competition, serve to shackle our industry?

To ask the question is to answer it. It is patently clear that, in this increasingly international market for investments and investment services, American firms such as Stein Roe must expand their horizons if they are to continue to grow and prosper. But in the investment business, as in any other service which is built on specialized expertise, trust, confidence and reputation, expanding into a new market is not so simple a matter as opening a new office in a new location and waiting for the customers to present themselves.

For an American firm to attempt to develop by itself an expertise in foreign securities markets is a difficult task --one which our firm once attempted but quickly abandoned several years ago. Likewise, attracting foreign clients to invest in U.S. securities, without having an established reputation in foreign financial circles, is also a difficult task.

Our creation of a joint venture with several foreign investment institutions is an attempt to overcome those difficulties--giving our domestic firm an international exposure and an international investment capability, at a much lower cost and with lower business risk than if we were to attempt to expand directly and alone into foreign markets. Under present United States tax law, this undertaking is entirely consonant with the laws and practices of the United Kingdom, Switzerland, and Japan--the home countries of our joint venture partners. These countries consider it wise policy not to penalize their residents who expand into international markets.

What our firm brings to the joint venture, aside from its investment expertise in U.S. securities markets, is its base of U.S. investor-clients--and it is that base of clients which most interests our foreign partners. Enactment of the foreign investment company provisions of the Code proposed in section 625 of H.R. 3838 would eliminate the possibility of attracting any such U.S. investors. Consequently, new investment of this type in the United States would dry up.

Our foreign partners also bring an established client base to us, allowing Stein Roe the opportunity to expand into those foreign markets. In the past, foreign investors in the United States have tended to be the exclusive province of foreign financial advisors. Joint ventures such as ours can change this. As an example, in the context of our joint venture we will be providing services to Japanese investors--and this would mark the first significant American penetration of the Japanese market. But this opportunity will be lost if we cannot attract our clients to invest in the foreign investment company.

The proposed change in the taxation of foreign investment companies would make it impossible for us to induce any U.S. investor to purchase shares in the company we have created--since the proposal would actually place such investments at a tax disadvantage in comparison with other investment alternatives, both domestic and foreign. Not only would U.S. investors in foreign investment companies be taxed on income they haven't received, but they would also be denied the capital gains treatment accorded investors in a domestic regulated investment company on capital gains earned by the company's investments.

In short, if Stein Roe is unable to deliver U.S. investors to the joint venture, the future of the venture and the future of our effort to expand our firm's services internationally would be effectively frustrated.

The Tax Theory Underlying the House Bill Provision Relating to Foreign Investment Companies is Defective -- It Violates the "Ability To Pay" Principle

To the extent that it is at all germane to consider at this time * the technical rationale for the proposed changes in the House bill, we believe the tax theory which underlies the proposal is defective in that it violates a long-standing principle of federal income taxation--the "ability to pay" principle--by requiring the investor to pay a tax on income which he has not received. Exceptions to that principle have appropriately been made in those situations (for example, foreign personal holding companies) where it is clear that the shareholder is utilizing the corporation to defer taxation of income which is in fact within his control. However, the current proposal would extend such taxation to the investor in a majority foreign-owned investment company--a situation where not only has the investor not received any income on which he should be taxed, but also does not have sufficient control, even acting in concert with other U.S. investors, to compel the payment to him of a dividend. Such an extension of the doctrine of

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* We repeat, the economic health of Americans competing in foreign markets is much more vital to the Nation's welfare at this time than is a nicety in tax reform--even if the House bill provision were conceptually well-founded.

"constructive receipt" is both surprising and troubling (if not actually unconstitutional).

Proposed Changes Raise Difficult Administrative Problems Which May Make It Unworkable

In many cases the proposed changes would be very difficult to administer, as the investor would need to be able to compute his proportionate share each year of the earnings and profits of the foreign investment company. In many situations, the information necessary to do so may be altogether unavailable or, if available, presented on a basis insufficient to satisfy Internal Revenue Service rules.

Conclusion -- The Finance Committee Should Not Change the Present Law Relating to Foreign Investment Companies

The foregoing discussion merely suggests some of the difficult problems created by the new foreign investment company provision contained in section 625 of the House bill. A complex issue such as this deserves extensive hearings, thoughtful analysis, and then careful drafting to avoid unfairness and damage to American competitiveness abroad. None of this has been done.

In summary, we believe the House bill's provision (1) is ill-conceived from a tax theory and administration standpoint, (2) would have a very negative impact on U.S. investment firms such as ours in their efforts to export their services, and (3) would also have a negative influence on the importation of foreign investors' capital to U.S. securities markets.

Accordingly, we respectfully and earnestly submit that section 625 of the House bill should not be included in any tax reform legislation recommended by this Committee.

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TRIANGLE TUBE® TRIANGLE TUBE & SPECIALTY CO. INC.

• THOMAS AVE. RD#5, BOX 122-J • WILLIAMSTOWN, NEW JERSEY 08094 •

PHONE 609-728-1700 — TELEX 703278

The Honorable Robert Packwood
Chairman
Senate Committee on Finance
219 Russell State Office Building
Washington, DC 20510

February 19, 1986

Attention: Ms. Betty Scott-Boom

Subject: HR 3838 Tax Reform Act of 1985

The tax reform bill proposed by the House Ways and Means Committee would have a series of adverse effects on the economy, particularly on capital-intensive heavy industrial sectors, but also on GNP and unemployment. In order to gauge the implications of the Ways and Means proposal, the econometric research firm Lawrence Meyer and Associates simulated the Washington University Macromodel out to 1991. This study was conducted independently, and not at NAM's behest. Assuming that the Federal Reserve holds the growth of bank reserves constant (i.e., does not offset the tax changes through reflation), the following conclusions emerge.

1. Lower Growth - The growth rate of real GNP is lower by magnitudes of up to -1.5% per year relative to the CBO baseline forecast for the economy.
2. Lower Capital Formation - Fixed investment is lower by up to -2.5% annually. Investment in producer durables is lower by up to -2.5%, non-residential structures by up to -2.8%, and residential structures by over -1%. The real capital stock in producer durables is lower by over -$100 billion (in constant 1972 dollars).
3. Losses in Competitiveness - Exports are lower by up to -1.1% annually. The United States will place itself at a serious competitive disadvantage by deleting the kinds of investment incentives that are available to industry in other countries. With the House Ways and Means proposal, the United States would go from having one of the better capital cost recovery systems to the single worst system of all industrial nations.
4. Higher Unemployment - The civilian unemployment rate is 1.3 percentage points higher than the baseline, i.e. by 1991, the unemployment rate is 6.7%, compared to 5.4% in the baseline.
5. Larger Deficits - The Federal deficit in constant 1972 dollars would be $25.2 billion larger in 1991 than in the baseline.
6. Sectoral Shifts Away from Investment - Under the current law, baseline gross fixed investment reaches 18.3% of GNP in 1991; under the Ways and Means proposal, the investment share falls to 16.1% of GNP.

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The only way in which the economy can grow as rapidly as under the CBO baseline is if the Federal Reserve attempts to offset the Ways and Means proposal through monetary reflation. However, this still produces a shift in the output mix away from investment. Even with a full monetary offset, the share of GNP comprised by gross investment falls by roughly a percentage point under the Ways and Means proposal.

In sum, the House Ways and Means proposal would represent a self-imposed disaster for the American economy. The "best" that can be expected is a process of deindustrialization and declining investment share. At worst, the result would be shortfalls in GNP, employment and exports as well as capital formation.

I request my letter be heard at the hearing for this Act. As a company who manufactures for both the U.S.A. Market and over-seas, you can certainly understand our concern if the HR 3838 is signed.

Thanking you, in advance, for taking the time to listen to us.

Sincerely yours,

Mr. Charles J. Hennessey--Purchasing Agent
TRIANGLE TUBE & SPECIALTY CO., INC.
CJH:djw

CC: Mr. Davis W. Stoddard--Public Affairs Representative
File

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TRIBORO
Electrical wiring devices

TRIBORO ELECTRIC CORP.
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February 18, 1986

The tax reform bill proposed by the House Ways and Means Committee would have a series of adverse effects on the economy, particularly on capital-intensive heavy industrial sectors, but also on GNP and unemployment. In order to gauge the implications of the Ways and Means proposal, the econometric research firm, Lawrence Meyer and Associates, simulated the Washington University Macromodel out to 1991. Assuming that the Federal Reserve holds the growth of bank reserves constant (i.e., does not offset the tax changes through relation), the following conclusions emerge:

1. LOWER GROWTH
2. LOWER CAPITAL FORMATION
3. LOSSES IN COMPETITIVENESS
4. HIGHER UNEMPLOYMENT
5. LARGER DEFICITS
6. SECTORAL SHIFTS AWAY FROM INVESTMENT

The only way in which the economy can grow as rapidly as under the CBO baseline is if the Federal Reserve attempts to offset the Ways and Means proposal through monetary reflation. However, this still produces a shift in the output mix away from investment. Even with a full monetary offset, the share of GNP comprised by gross investment falls by roughly a percentage point under the Ways and Means proposal.

In sum, the House Ways and Means proposal would represent a self-imposed disaster for the American economy. The "best" that can be expected is a process of deindustrialization and declining investment share. At worst, the result would be shortfalls in GNP, employment and exports as well as capital formation.

It is requested that the above statement be included in the hearing record for HR 3838.

TAX REFORM MUST BE FAIR, SIMPLE, AND ECONOMICALLY SOUND.

Sincerely,

Murray B. Yarmark

Murray B. Yarmark
President
TRIBORO ELECTRIC CORP.

MBY/bp

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TRINITY COLLEGE · HARTFORD · CONNECTICUT · 06106

Office of the President

February 14, 1986

Senate Finance Committee
c/o Ms. Betty Scott-Boom
Committee on Finance
Room SD-219
Senate Dirksen Office Building
Washington, D. C. 20510

Dear Members of the Senate Finance Committee:

I am writing to urge the continuation of the long-standing tax exemption for pension plan funds held by TIAA - CREF, which exemption would be terminated under Section 1012 of H. R. 3838. TIAA - CREF holds the retirement funds for approximately one million current and retired employees of 3,600 non-profit educational organizations. For more than 65 years, participating non-profit institutions have relied on the tax-exempt status of the TIAA - CREF system when depositing their retirement funds.

The multi-employer TIAA - CREF's pension system is unique and should not be taxed as a commercial insurer. TIAA - CREF pension funds are portable and serve only members of non-profit educational instititutions. Furthermore, TIAA - CREF itself is a non-profit organization. It is important to note that every dollar of pension contributions and the income therefrom for TIAA - CREF funds are used for pension or related benefits for tax-exempt educational institutions.

Commercial insurers differ from TIAA in that they may accumulate their profits, reserves and surplus for purposes which ultimately inure to private commercial benefit. TIAA - CREF, however, cannot use any of its contingency funds to expand into other types of business activities.

Section 1012 of H.R. 3838 would terminate the long-standing tax exemption of the TIAA - CREF pension system, while continuing tax exemption for virtually all other pension funds. These results would treat higher education's pension system unfairly and reduce participants' pension benefits. Therefore, I urge you to continue the long-standing tax-exemption of the TIAA - CREF pension system.

Cordially,

James F. English, Jr.
President

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STATEMENT
on
THE EFFECTS OF PROPOSED TAX REFORM ON THE INTERNATIONAL COMPETITIVENESS OF U.S. INDUSTRIES
before the
SENATE FINANCE COMMITTEE
for the
U.S. CHAMBER OF COMMERCE
by
Dr. Richard W. Rahn*
February 18, 1986

The U.S. Chamber of Commerce welcomes the opportunity to submit testimony on the effects of H.R. 3838 on the economy and international competitiveness.

The Chamber supports tax reform that would lower rates and broaden the base in the interest of stimulating capital formation, technological advancement, international competitiveness, and job creation. We oppose H.R. 3838 because it does not meet these standards.

The Chamber is extremely concerned about the effective dates in H.R. 3838. In order not to disrupt productive business activities, we urge Congress to include prospective effective dates for any tax reform legislation which may be enacted.

The Chamber is greatly concerned with the effect of tax reform on international competitiveness. Several international tax provisions in H.R. 3838, including the foreign tax credit and sourcing rules, would have an

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*Vice President and Chief Economist, U.S. Chamber of Commerce

The Chamber of Commerce of the United States is the world's largest federation of business companies and associations and is the principal spokesman for the American business community. It represents almost 180,000 businesses plus several thousand organizations, such as local/state chambers of commerce and trade/professional associations.

More than 91 percent of the Chamber's members are small business firms with fewer than 100 employees, 57 percent with fewer than 10 employees. Yet, virtually all of the nation's largest companies are also active members. We are particularly cognizant of the problems of smaller businesses, as well as issues facing the business community at large.

Besides representing a cross section of the American business community in terms of number of employees, the Chamber represents a wide management spectrum by type of business and location. Each major classification of American business—manufacturing, retailing, services, construction, wholesaling, and finance—numbers more than 12,000 members. Yet no one group constitutes as much as 29 percent of the total membership. Further, the Chamber has substantial membership in all 50 states.

The Chamber's international reach is substantial as well. It believes that global interdependence provides an opportunity, not a threat. In addition to the 54 American Chambers of Commerce Abroad, an increasing number of members are engaged in the export and import of both goods and services and have ongoing investment activities. The Chamber favors strengthened international competitiveness and opposes artificial U.S. and foreign barriers to international business.

Positions on national issues are developed by a cross section of its members serving on committees, subcommittees and task forces. Currently, some 1,800 business people participate in this process.

adverse impact on the ability of U.S. companies to compete with our trading partners. In addition, the bill's treatment of capital investment would reduce the ability of U.S. business to compete in international markets.

I. Cost of Capital

The tax treatment of capital investment has a substantial but often ignored effect on the ability of American business to compete in international markets. Capital cost recovery allowances, the investment credit, capital gains taxation, the tax treatment of research expenditures, and other tax provisions have a strong impact on the after-tax cost of capital investment.

Because capital is one of the primary factors of production, changes in the tax law that drive the cost of that factor-input up will increase producers' marginal costs and, therefore, the price at which they are able to market their goods. As domestic producers' selling prices increase, domestically produced goods become less competitive in export markets and in domestic markets when competing with goods imported into the United States.

A. The Accelerated Cost Recovery System Caused Record Capital Formation

The Accelerated Cost Recovery System (ACRS) was a cornerstone of the Economic Recovery Tax Act of 1981 (ERTA) and exceeded the goals of even its most optimistic supporters. Replacement of the inadequate Asset Depreciation Range (ADR) system with ACRS cut the after-tax cost of capital and allowed businesses to make the investment in plant and equipment needed to drive the recovery. The combination of ACRS and the Investmont Tax Credit (ITC) successfully reduced the tax bias against investment and caused nonresidential fixed investment (plant and equipment) to increase by 31.5 percent in the 10 quarters since the recovery began in the fourth quarter of 1982. This is the highest rate of capital formation in any post war recovery. The average increase during post war recoveries is 16.2 percent, half of the present rate.

Dr. Michael Boskin, of Stanford University, estimates in his study of investment incentives for the National Chamber Foundation that "ACRS and the ITC was [sic] responsible for about 25 percent of the net investment in the 1982-84 period."[1] Thus, if the investment aspects of ERTA had not been passed, GNP would have approximately 79 billion dollars less (1982-1985), and the federal government would have received 33.5 billion dollars less in tax revenue. Dr. Boskin estimates the net cost of capital for equipment due to ERTA/TEFRA was reduced by three percent. But according to a study using the Washington University macroeconomic mode by Laurence Meyer and Associates, H.R. 3838 would increase the net cost of capital for equipment by approximately 18 percent.

Increased capital formation boosts productivity, employment, and competitiveness. Because pre-ERTA allowances were insufficient, the U.S. economy had stagnated and become uncompetitive. Our capital stock was much older than our trading partners' because our allowances had been insufficient for decades. Any further cutbacks in depreciation allowances will undermine the progress made to date.

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[1] M. Boskin, Impact of the 1981-1982 Investment Incentives on Business Fixed Investment (National Chamber Foundation, 1985), p. vii.

B. Capital Cost Recovery Under Tax Reform

Many tax reform proposals would reduce capital cost recovery allowances for equipment and would harm certain types of investment. The Real Cost Recovery System (RCRS) is the system originally proposed by the Treasury Department in November 1984. The President proposed the Capital Cost Recovery System (CCRS) in his May 1985 proposal. Bradley-Gephardt would replace ACRS and the ITC with the Simplified Cost Recovery System (SCRS). SCRS would employ lives similar to the old ADR class lives but would allow the use of the 250 percent declining balance method.

H.R. 3838 would replace ACRS and ITC with the least adequate capital cost recovery system since the Great Depression. The so-called Incentive Depreciation System (IDS) would employ lives similar to the old ADR class lives and allow property to be depreciated at a 200 percent declining source rate.

Proposals like Kemp-Kasten, Roth-Moore and others, however, would not substantially increase and would sometimes reduce the cost of capital. Kemp-Kasten's Neutral Cost Recovery System (NCRS) would provide the present value equivalent of expensing while Roth-Moore would phase-in actual expensing.

Table I reflects the effect of the various proposed capital cost recovery plans on the after-tax cost of capital. The table reflects the effect of corporate tax rate reductions, dividend deductibility, the investment tax credit, and depreciation allowances.

TABLE I

Depreciation System	Change in the Cost of Capital Compared to Present Law (percent)[2]	
	ACRS-ITC 3-Year	ACRS-ITC 5-Year
Neutral Cost Recovery System (Kemp-Kasten)	+1	+2
Simplified Cost Recovery System (Bradley-Gephardt)	+5	+16
Real Cost Recovery System (Treasury)	+2	+9
Capital Cost Recovery System (Reagan)	+1	+6
Incentive Depreciation System (H.R. 3838)	+8	+20

H.R. 3838 would result in billions of dollars of lost investment. Without this investment, the economy will grow more slowly than it otherwise could, the U.S. will fall behind technologically, and American business will be less able to compete in international markets. The Washington University simulation found that as a result of these changes the trade deficit would be six percent greater in 1991 than if tax reform were not enacted.

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[2] These figure reflect typical changes in class under the proposed systems. Certain classes of property may be affected diferently.

Arthur Andersen and Company has conducted a study comparing present U.S. capital cost recovery allowances and those under H.R. 3838 to those of 15 of our major trading partners. Its study shows that H.R. 3838 substanially would impair the ability of American business to compete with companies manufacturing in these countries. The chart below sets forth the present rank (1 through 16) and the rank under H.R. 3838, which would put American industry near the bottom of the list.

	Rank	
Class Property	Present Law	House Bill
Two (Computers)	4	10
Three (Mining)	4	15
Four (Textiles)	5	16
Five (Electrical)	9	14

II. Taxation of Foreign Income

Increases in the cost of capital impede the ability of U.S. firms to compete with foreign made goods because U.S. manufacturers would have to raise the price of their products to compensate for the increased cost. The provisions that affect the taxation of foreign activities of U.S. shareholders will affect the competitiveness of U.S. firms operating in international markets.

A. Foreign Tax Credit

Although H.R. 3838 purports to retain the overall limitation for calculation of the foreign tax credit, the creation of separate limitations for various types of income has the effect of eroding the benefits of an overall limitation. The Administration, in its tax reform plan, proposed calculating the foreign tax credit on a per country basis. This plan was rejected, both because of its difficulty in administration and because of its anticompetitive effects.

The U.S. rules for calculating the foreign tax credit are designed not only to prevent double taxation of foreign source income but also to limit the credit to U.S. tax imposed on income earned and taxed overseas. The credit is designed so that it does not reduce U.S. tax on income earned from operations in the United States. This is true whether or not an overall limitation, a per country limitation, or a hybrid plan, such as in H.R. 3838, is used.

The overall limitation permits averaging of taxes paid in high-tax countries with those paid in low-tax countries. Although the Committee Report for H.R. 3838 regards averaging as a potential abuse, averaging of bona fide foreign taxes imposed on foreign source income is a proper attribute of a foreign tax credit. This is true because within the context of global business operations averaging is a realistic way of dealing with the complexities of international trade in which business is ordinarily conducted on an integrated basis. Most countries that avoid international double taxation either use an overall limitation (as does Japan), exempt direct investment income, or use a per country limitation that permits a form of averaging. (See Appendix, "Survey of Taxation of Foreign Source Income by Certain Major Industrial Countries".)

Our major trade rival, Japan, has an overall limitation. Additionally, Japan has a network of tax sparing treaties, which allow Japanese firms to credit the tax foregone by the host country against tax liability to Japan. When combined with the use of the overall limitation, this provides Japanese companies a credit for taxes that were never paid. The Japanese system provides Japanese business with a tax advantage over the United States even under current law, which would be greatly exacerbated if the foreign tax provisions of H.R. 3838 were adopted.

Canada, France and Germany employ a mixed system primarily relying upon exemption (under treaty or by statute) and permitting foreign tax credits under the per country method where exemption does not apply. However, in those countries using a per country method, including the United Kingdom, a form of averaging is permitted through the use of third country holding companies.

The per country proposal by the Administration and the separate limitations approach included in H.R. 3838 would cause U.S. companies to be subject to greater double taxation than are their foreign competitors and, thus, increase their competitive disadvantage.

B. Source Rule Changes

Our tax laws define the source, foreign or U.S., of income and expenses for the purpose of defining the scope of U.S. taxation and where primary jurisdiction for taxation of U.S. citizens is conceded to a foreign country because income is deemed to be earned in that country. The source of income and expenses of U.S. taxpayers becomes part of the formula for determining the amount of the foreign tax credit allowed to U.S. taxpayers for taxes paid to foreign jurisdictions, because the credit is allowed only to the extent foreign taxes are paid on "foreign source" income.

1. Export Sales

The proposed changes with regard to the sourcing rules for sales will result in a tax increase for U.S. exporters. Under current law, income from sales of personal property is considered to be earned at the place of sale, as determined by passage of title (i.e., contemporaneous passage of the significant incidents of ownership). H.R. 3838 generally would consider such income to be earned in the country of the taxpayer's residence unless the seller maintains a fixed place of business outside of its country of residence and that fixed place of business participates materially in the sale generating the income. However, all sales to a taxpayer's foreign subsidiaries would be sourced at the seller's residence, and a fixed place of business maintained by an independent distributor would not be attributed to the seller for purposes of this source rule.

The effect of this proposal will be to increase directly the tax earned on income from export sales. Last year the Administration proposed and Congress enacted the Foreign Sales Corporation provisions because they recognized the importance of encouraging U.S. exports. Yet, the proposals to change the source of income rules as applied to export transactions substantially undercut that effort without any analysis of the impact such a change might have on U.S. trade. Indeed, the obvious effect of this proposal would be either to increase the tax on U.S. exports or to force exporters to establish more fixed places of business outside of the United States. We query whether our national policy should be to do either.

2. Allocation of Interest Expense

Under present law, interest expense incurred by members of a related group of corporations is allocated and apportioned between domestic and foreign sources on a separate company basis. H.R. 3838 would require that the interest expense incurred by one or more members of a related group of corporations be allocated to all members of the group. The Administration has proposed this change because of a concern that taxpayers would be able to manipulate the location of borrowings within a consolidated group of corporations in order to maximize tax advantages.

Borrowings of subsidiaries are made for solid business, not tax-motivated, reasons. Where a subsidiary is a regulated common carrier, the tariff, which includes an interest element in the rate schedule, will be set by the Interstate Commerce Commission. Captive domestic finance companies doing business with third parties are self-sustaining business operations supported by their own borrowings. It is only on an arbitrary basis that interest expense incurred by such a finance company would be allocated to income from the foreign manufacturing subsidiary of the U.S. parent which may finance its own operations. Also, debt may be incurred by a subsidiary in order to limit liability, where the creditor's only recourse is against the subsidiary and not against the parent. This situation may be of particular concern where a subsidiary is located in politically unstable countries. Finally, a loan may be structured whereby the revenues earned from the financial asset will be the security on the debt.

The proposed rule will favor a foreign controlled U.S. group by permitting greater interest expense allocations to U.S. income where there is a foreign parent than in the case of a chain of ownership of U.S. and foreign corporations controlled by a U.S. parent. The proposal would almost certainly result in overallocation of expense to foreign source income of U.S. companies.

The proposal to spread interest expense throughout a related group of corporations without regard to economic reality and without regard to the computation of foreign income on which foreign taxes are actually levied is unwarranted. This proposal would place U.S. owned companies at a competitive disadvantage to foreign owned companies operating in the United States, which would not be subject to these rules.

C. Subpart F

The United States generally does not tax income earned abroad by a U.S. taxpayer until it is repatriated. This system is commonly referred to as "deferral." The theory behind deferral is that U.S. shareholders of foreign corporations should not be taxrd on undistributed foreign corporate earnings for the same reason that U.S. shareholders of U.S. corporations are not taxed on undistributed domestic corporate earnings. The corporation and its shareholders are considered separate entities for tax purposes. As a result, profits earned through a corporation are taxed twice, once at the corporate level and again to the shareholders when dividends are paid. If the shareholders were to be deemed to be the corporation, there would be no justification for this double tax.

Subpart F was created to deal with abusive situations in which money was being kept overseas in tax haven countries in order to avoid U.S. tax on that income. Therefore, certain types of passive income are designated as Subpart F income and are subject to current U.S. taxation, whether or not such income is repatriated to the United States.

H.R. 3838 proposes to tax undistributed earnings resulting from certain types of active business income, earned through banking, insurance, and shipping operations, currently. The Chamber believes that deferral should be maintained for active business income and that no distinction should be made for the line of business of a particular company.

The proposal to tax the income of a foreign subsidiary whether or not it is received by the U.S. parent is, in reality, a proposal to accelerate the payment of U.S. taxes. This would be analogous to requiring individual shareholders of U.S. corporations to pay personal income taxes on profits that had been earned by the corporation but not paid in dividends to the shareholders. No other country today taxes unremitted earnings of foreign affiliates of their corporations.

D. Foreign Sales Corporations

In 1984, Congress replaced the Domestic International Sales Corporation (DISC) provisions of the tax code with the Foreign Sales Corporation (FSC) provisions, because of complaints by certain signatories to the General Agreement on Tariffs and Trade (GATT) that DISC violated that agreement. DISC, and later FSC, were designed to make up for the competitive disadvantage suffered by U.S. exporters vis-a-vis their trading partners which have more beneficial systems of taxation. In its application to income from the sale of exports, FSC is designed to mimic a territorial system of taxation, enjoyed by many of our competitors, whereby income earned outside of the country is not taxed by that country.

H.R. 3838 would reduce the current benefit under the FSC provisions. The Chamber believes that a reduction in the benefits of a provision designed to aid exporters, at a time when the trade deficit is so high, is a step in the wrong direction.

E. Income of Americans Working Abroad (Section 911)

Section 911 provides an exclusion from U.S. income taxation for a portion of the income of Americans working overseas. This provision was enacted to encourage Americans to work abroad, in order to help promote the export of U.S. manufactured goods and services. H.R. 3838 would reduce the benefits currently received under section 911. We believe that the policy concerns behind the enactment of section 911 still exist and that no changes should be made in these provisions.

III. Research and Development

The U.S. Chamber applauds H.R. 3838 for including the three-year extension of the research and development tax credit. The research and experimentation tax credit has stimulated research and development in this country since it was enacted in 1981. Extension on the credit will assist in greater technological advancement, the improvement of our ability to compete internationally, and job creation. The U.S. Chamber also supports the revised definition of qualified research to more narrowly targeted activities.

In total research and development expenditures, expressed as a percentage of GNP, the United States has led the free world since at least the late 1960s. In recent years, however, our lead has substantially narrowed.

Research expenditures are a crucial element in improving our ability to compete abroad. A permanent research credit would offer the stable and predictable tax policy necessary to compete successfully internationally.

A report released in February 1985 by the Brookings Institution and Data Resources, Inc. documents the role of industrial research in fostering economic expansion and international competitiveness. Prior to the enactment of the R & D credit, the U.S. devoted the smallest share of GNP to private research of any industrial nation. After the credit was enacted in 1981, the gap began to close.

The new report provides quantitative estimates of the economic benefits of a permanent credit. The most conservative estimate in the report shows that, upon enactment of the permanent credit, annual benefits to GNP would be $1.2 billion in 1986 and $2.9 billion in 1991. "Best case" estimates show benefits as high as $7.5 billion in 1986 and $17.7 billion in 1991.

The credit will stimulate additional research spending. Increased research and development ultimately results in increased profits, which, in turn, translates into revenues to the federal government.

Investment in research is, by nature, a long-term proposition. If we are to achieve our goals of capital formation, technological advancement, international competitiveness, and job creation, research expenditures must be made at high levels for many years. A stable and predictable tax policy is necessary for such expenditures to continue. Consequently, we recommend making the research credit a permanent feature of the tax code.

We also recommend that Congress retain provisions in the tax code that allow research expenditures to be expensed. Research expenses, like other expenses, should be deducted in the year incurred rather than amortized over long periods. Only expensing, as under present law, eliminates the tax bias against investment in research.

Conclusion

Foreign investment and operations by U.S. businesses provide significant benefit to the U.S. economy in the form of jobs, increased exports, trade balance, and tax revenue. At a time when the President's Commission on Industrial Competitiveness has called for the elimination of practices that are impeding the ability of U.S. companies to keep pace with the "new reality of global competition,"[3] H.R. 3838 proposes to introduce new barriers to the penetration of foreign markets.

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[3] The Report of the President's Commission on Industrial Competitiveness, Global Competition; the New Reality (January 1985).

ADVANCING VOLUNTARY LEADERSHIP IN A CHANGING WORLD

Chamber of Commerce of the United States
TAX POLICY CENTER
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APPENDIX

Survey of Taxation of Foreign Source Income by Certain Major Industrial Countries.

Set forth below is a review of the tax rules of other major industrial countries applicable to foreign source income earned by domestic corporations. This review shows that most foreign source direct investment income earned by foreign multinational companies is either exempt from home country tax or, if taxed, is subject to the equivalent of an overall limitation. To briefly summarize these descriptions, foreign source direct investment income earned by multinational companies based in Australia, France and the Netherlands is generally exempt from home country tax. Germany (by treaty) and Italy (by dividend exemption) also allow for significant exemption of foreign source income. Belgium exempts most foreign source income, and any foreign source income subject to tax can be offset by foreign tax credits computed under an overall limitation. Japan taxes foreign source income with foreign tax credits limited to one tier but computed under an overall limitation. Even in the United Kingdom, where a form of per country limitation is employed, averaging of high and low foreign tax rates has been achieved via an appropriate foreign corporate structure (as was the case with the per country limitation under prior U.S. law).

AUSTRALIA

A resident corporation of Australia is technically liable for Australian corporate tax on its worldwide income. Double taxation is avoided by a combination of tax exemptions, rebates and credits. Foreign subsidiaries of Australian corporations are not taxed in Australia (i.e. no global assessments), but dividends, etc., remitted to Australia are subject to the rules set out below.

The foreign branch income of an Australian corporation is not taxable in Australia, provided the income is subject to tax in the country of source. (This rule applies even if the foreign tax rate is considerably less than the Australian tax rate.)

Dividends received by an Australian corporation from a foreign corporation are includable in taxable income. However, the foreign dividends, provided they relate to non-Australian source income, are effectively received tax-free as the Australian tax applicable thereto is fully rebated. In the case of closely held corporations, this rebate is conditional upon the dividend being redistributed to individual shareholders within 22 months, failing which tax at 50 percent of the undistributed amount is payable.

Interest derived by an Australian corporation from foreign sources is exempt from Australian tax, provided the interest is taxed in the country of source. If the foreign tax applicable to the interest is limited by the terms of a tax treaty, the interest is taxable in Australia with the allowance of a foreign tax credit.

Royalties received by an Australian corporation from foreign sources are exempt from Australian tax, provided they are taxed in the country of source. If the foreign tax applicable to the royalties is limited by the terms of a tax treaty, the royalties are taxable in Australia with the allowance of a foreign tax credit.

The above foreign tax credits are limited to the amount of Australian tax otherwise applicable to the income received. The tax credit is calculated separately for each item of income.

BELGIUM

Belgian corporations are technically subject to corporate income tax on their total income, including income derived from foreign sources.

Income from foreign branches forms part of a Belgian corporation's taxable income. The Belgian corporate income tax is, however, reduced to one-fourth on foreign branch income that has already been taxed abroad. Furthermore, the income of a foreign branch is fully exempted from Belgian corporate income tax when such branch is located in a country with which Belgium has concluded a tax treaty.

Dividends received by a Belgian corporation from foreign sources are subject to Belgian corporate income tax. However, a deduction equal to 95 percent of dividends received is allowable in computing taxable income, provided that the shares which generated such dividends were held by the taxpayer company for its entire fiscal year. If the shares were not held during the entire year, the dividends are fully taxable, but a flat foreign tax credit of 15 percent of the dividends received is allowed.

Foreign source interest and foreign source royalties form part of the normal taxable income of a Belgian company. A flat foreign tax credit of 15 percent of the amount received is granted if the income was subject to withholding tax at source.

Belgian foreign tax credits are subject to an overall limitation.

CANADA

Corporations resident in Canada are subject to Canadian federal income taxes on their worldwide income, subject to credits for foreign income taxes paid on income derived from non-Canadian sources. Under Canadian law, dividends are exempt from taxation if received from a subsidiary in a treaty country. Canada has entered into a broad tax treaty network.

Canadian law does not provide for a foreign tax credit for the underlying foreign taxes attributable to dividends received by a Canadian corporation from a foreign affiliate. In lieu thereof, Canadian law provides that such underlying foreign taxes are eligible for a deduction on a formula basis in computing the Canadian corporation's taxable income. In addition, any foreign withholding taxes imposed on the dividend are subject to a deduction-from-income mechanism (rather than a tax credit). The total deduction is computed under a formula that is designed to result in the imposition of Canadian tax and foreign underlying and withholding taxes on the dividend from the foreign affiliate at a rate equivalent to the Canadian corporate tax rate. If a Canadian corporation receives a dividend from a first-tier foreign subsidiary and such dividend is derived from the earnings of both the first-tier foreign subsidiary and a second-tier foreign subsidiary, the earnings and the foreign taxes of the two subsidiaries are aggregated for purposes of computing the Canadian deduction.

A Canadian corporation is entitled to claim a credit for foreign taxes paid on foreign branch income as well as foreign withholding taxes.

The foreign tax credit is allowed to Canadian corporations on a per country basis on dividends received from a subsidiary in a non-treaty country.

FRANCE

The French tax system is based on the principle of territoriality. Except for a few limited situations, French tax law is not applicable to business activities conducted outside French territory. Thus, income earned by a foreign branch of a French corporation is generally not subject to French income tax.

French parent companies receiving dividends from their foreign (or domestic) subsidiaries benefit from a "participation exemption." To qualify for the participation exemption, the French corporation must hold shares representing at least 10 percent of the issued capital of the subsidiary. A qualifying parent company receiving a dividend from the affiliate may deduct from its taxable income an amount equal to 100 percent of the dividend received, but should disallow deductible expenses up to an amount equal to 5 percent of the gross dividends received (or less if the expenses of holding the shares, incurred by the parent company, are not high).

Foreign source dividends not qualifying for the participation exemption, foreign source interest, and foreign source royalties are includable in the taxable income of a French corporate recipient. If the foreign source country has concluded a tax treaty with France, foreign tax credits may be claimed for foreign withholding taxes imposed on the payments. The credit for withholding taxes paid to a treaty country is limited to the amount of French income tax due on the payments from the treaty country. In the absence of an income tax treaty, French law provides for a deduction (rather than a credit) for foreign taxes, i.e., income is recorded by a French taxpayer net of foreign taxes.

GERMANY

German corporations are liable for German corporation tax on their worldwide income whether derived from German or foreign sources. However, under most tax treaties concluded by Germany, profits of a foreign branch are exempted from German corporation tax. Profits of German companies in nontreaty countries or in treaty countries where the treaty does not provide for an exemption of branch profits are subject to German corporation tax, but a tax credit is given under German internal law for foreign income taxes paid. There are some German treaties, such as the treaty with Switzerland, which exempt profits of a branch in the other treaty state only if the branch engages in active business operations.

Dividends received by a German corporation with respect to a 10 percent or more shareholding in a company situated in a treaty country are generally exempt from German corporation tax under the provisions of the treaty. Dividends received by a German corporation with respect to a 10 percent or more shareholding in a company situated in a nontreaty country are taxable in Germany for corporation tax purposes. In this situation, income taxes paid by the foreign subsidiary are claimable by the parent under the indirect foreign tax credit rules even though they are paid by the subsidiary. Thus, the parent company can credit foreign income taxes paid by the subsidiary, as well as foreign withholding taxes paid on the dividend income, against its own corporation tax liability.

Interest and royalties received by a German corporation from foreign sources are subject to German corporation tax. A foreign tax credit is given for any foreign income taxes withheld on such payments.

The German foreign tax credit is computed on a per country basis.

ITALY

An Italian corporation is subject to Italian corporate income tax on all income, whether produced in Italy or abroad. A foreign tax credit is allowed for foreign taxes paid on a corporation's foreign source income determined on a country by country basis.

Only 40 percent of the dividend income received by Italian companies from foreign-associated companies (generally, more than 10 percent stock ownership) is included in taxable income for corporate income tax purposes. Foreign withholding taxes imposed on the dividends are eligible for foreign tax credit. In a recent ruling, the Ministry of Finance, clarified that whenever the taxpayer benefits from the 60 percent exclusion, the credit is limited to 40 percent of the foreign withholding tax.

The amount of foreign tax credit depends on the reciprocity of treatment between Italy and the income-source country. If the foreign country grants a tax credit or an exemption for income of the same nature available in Italy, the tax paid abroad is credited against the Italian income tax but in an amount not exceeding that part of the Italian tax that is attributable to the foreign income. If the foreign country does not grant a tax credit or an exemption for income of the same nature available in Italy, a credit of up to 90 percent of Italian taxes attributable is given if the income was business income, or 50 percent if nonbusiness income. The tax credit cannot exceed the foreign taxes paid.

JAPAN

A Japanese corporation is subject to Japanese corporate income tax on its worldwide income.

A Japanese corporation is entitled to a tax credit against Japanese corporation tax for foreign income taxes paid. Foreign income taxes qualifying for the credit include foreign taxes that are imposed on the net income of a corporation or on gross revenue in lieu of a tax on net income, i.e., income tax imposed at source on interest, dividends, royalties, etc.

Creditable foreign income taxes include not only foreign income taxes imposed directly on a Japanese corporation but also foreign income taxes paid by certain foreign affiliates. This indirect credit is available to a Japanese corporation when it receives a dividend from a foreign corporation in which it owns directly at least 25 percent of the total issued shares. (Some tax treaties that Japan has concluded provide for a requisite percentage control lower than 25 percent. For example, the United States-Japan tax treaty provides that the requisite control is 10 percent of the total issued shares.)

The Japanese foreign tax credit limitation is computed on a worldwide basis. Thus, the total amount of foreign tax credit that may be claimed cannot exceed the amount of (pre-credit) Japanese corporate tax allocable to net foreign source income.

NETHERLANDS

A Dutch resident corporation is technically subject to Dutch corporate tax on its worldwide income. Double taxation of foreign source income is relieved through a variety of measures which employ either exemptions from income or foreign tax credits.

Foreign branch profits of a Dutch corporation are included in the worldwide income of the Dutch corporation and are subject to Dutch corporate tax. However, the Dutch corporation receives relief on its Dutch tax liability, i.e., if the foreign source income is subject to foreign income tax, the aggregate Dutch tax liability on worldwide income is reduced by the proportion that the foreign income bears to total income. This relief is tantamount to a full exemption from Dutch corporate tax of the foreign income concerned. The requirement that a foreign branch is subject to a foreign income tax in order to qualify for relief from double taxation, is deleted under most, but not all, tax treaties concluded by the Netherlands.

A Dutch corporation is exempt from Dutch taxes on all "benefits" connected with a qualifying shareholding, i.e., a "participation exemption." If a Dutch corporation owns at least 5 percent of the capital of a foreign corporation, if the foreign affiliate is not an investment company, and if the foreign affiliate is subject to an income tax in its home country, then dividends received by the Dutch corporation from the foreign affiliate qualify for the participation exemption and thus are exempt from Dutch corporate tax. In cases where the participation exemption does not apply, net dividends from abroad (after deduction of foreign taxes as an expense) are taxable in the Netherlands. The "participation exemption" exempts from corporate income taxes all benefits derived from a "qualifying participation." Capital gains (or losses) derived from a disposition of the stock are included in the term "benefits." The criteria to determine whether a shareholding in a foreign corporation qualifies as a "participation," is that the Netherlands company must own the stock as a participation as opposed to a portfolio investment. Such criteria generally implies that the foreign company itself cannot be a portfolio investing company. However, in BNB 1974-2 the Dutch Supreme Court held that the investment by a Netherlands company in 100 percent of the stock of an active German trading company can still constitute a portfolio investment and hence, not a participation for the Netherlands parent company. In its judgment in this case, the Supreme Court considered that the Netherlands company itself was a mere holding company managed by a bank, apparently without sufficient activities as a real holding company of a commercial or industrial group to indicate that the holding was not investing in the trading company as a portfolio investor. Pursuant to this court case, the Secretary promulgated a public ruling indicating that it was the view of the Ministry of Finance that, in similar situations the participation exemption would apply if the Netherlands holding company was an interposed holding company whereby the real group holding function is performed by a company or companies which are the direct or indirect parent company of the Netherlands company.

In addition to the relief method which applies to profits derived by a Netherlands company through a foreign branch, the Netherlands grants a credit for foreign source taxes on dividends, interest and royalties derived from developing countries. The right to a credit for foreign income taxes on dividends, interest and royalties are extended to tax treaty countries (in addition to developing countries) under applicable tax treaty. No credits are available for foreign income taxes levied on dividends which qualify for the participation exemption. The herein described foreign tax credit is limited by the lesser of (i) the amount of the foreign tax or (ii) the amount of the Netherlands tax otherwise applicable to the dividends, interest and/or royalties net of directly attributable expenses. For dividends a third limitation

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applies which equals a flat 25 percent of the dividends received. In principle, the credit for these categories of income operates as an overall limitation with an 8-year carry forward of excess foreign tax credits. Instead of applying the foreign tax credit, a Netherlands taxpayer can opt to deduct rather than credit the foreign tax on dividends, interest and royalties.

It might be important to note that the participation exemption is not considered as a special measure for the relief from international double taxation. It is not dealt with in either tax treaties or the unilateral method for relief from international double taxation. Rather, it is an integral part of the corporate income tax act which applies equally and indiscriminately to the domestic and foreign participations, although the requirements to qualify for the participation exemption with respect to a foreign participation are somewhat more extensive.

Interest and royalties from foreign sources are taxed as any other corporate income, with relief provided through the foreign tax credit mechanism.

The foreign tax credit allowed is the lesser of (i) the actual amount of foreign tax withheld or (ii) the amount of Dutch tax otherwise applicable to the interest and/or royalties.

UNITED KINGDOM

A U.K. resident company is subject to U.K. corporation tax on its worldwide income. Double taxation is reduced on foreign source income through the allowance of a foreign tax credit.

Where the foreign income consists of a dividend from a foreign corporation, the creditable foreign taxes include (i) any foreign tax withheld on the dividend payment, and (ii) the foreign income taxes paid by the foreign corporation on the underlying profits out of which the dividend is paid, provided the U.K corporation holds directly or indirectly at least 10 percent of the voting power of the foreign corporation.

The amount of U.K. foreign tax credit allowed is limited to the lesser of (i) the foreign tax paid on the particular income or (ii) the U.K. tax otherwise attributable to that particular income. Where foreign operations are conducted through a foreign subsidiary structure, foreign earnings and foreign taxes are generally aggregated at the first-tier level in computing the credit on a distribution up the tiers to the U.K. parent corporation. When aggregating the foreign tax credit at the first tier level, the underlying tax of lower tier companies from which a dividend is received, can be taken into account (insofar as they have paid dividends up the chain) provided that at each link in the chain there is ownership of at least 10 percent of the voting power. Therefore in a case where A has a wholly owned subsidiary located in a foreign country and B owns 15 percent of C which in turn owns 15 percent of D, underlying tax can be claimed in respect of all three companies, B, C and D, to the extent to which their profits have been ultimately distributed by way of dividend through to the U.K. company, A. Aggregating the credit at first tier level means that effectively you can pool high rate and low rate credits and thus overcome the problem that might arise if a dividend from a high tax country were remitted direct to the U.K. giving rise to excess credit while, at the same time, a dividend from a low tax country remitted to the U.K. gives rise to additional tax payable. Putting the low tax country company under the high tax country company will enable a blending of the rates, though it may generate a higher level of withholding tax.

Where two or more dividends are received by a company in the same accounting period the limitation must be applied in relation to each separate dividend.

Under U.K. law, interest costs are not attributable to foreign source income unless those interest costs have actually been incurred in the company receiving the foreign source income. In this way, a U.K. company may borrow for the purposes of an overseas investment, apply the funds received in paying up share capital for a subsidiary company and the subsidiary company then makes the investment. The foreign source dividends received by the subsidiary company attract full tax liability, subject to double taxation relief. Those dividends when received can then be passed on by way of dividend to the parent company with a neutral tax effect. The parent company sets off the interest cost either against other U.K. source taxable income or, if it does not have sufficient income of that nature, it sets it off by way of group relief against U.K. source income of other U.K. subsidiary companies.

STATEMENT
# of the
UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS

ON

H.R. 3838,

U.S. HOUSE OF REPRESENTATIVES TAX REFORM BILL OF 1985,

TO THE

U.S. SENATE COMMITTEE ON FINANCE

February 12, 1986

UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS
1212 Avenue of the Americas, New York, New York 10036 (212) 354-4480

EXECUTIVE SUMMARY OF THE UNITED STATES COUNCIL FOR INTERNATIONAL BUSINESS TO SENATE COMMITTEE ON FINANCE ON H.R. 3838

The United States Council for International Business represents American business in the major international economic institutions and before the executive and legislative branches of the U.S. government. Its primary objective is to promote an open system of world trade, finance, and investment. Through its affiliations with the Business and Industry Advisory Committee to the OECD, the International Organisation of Employers, and the International Chamber of Commerce, the Council officially participates in the OECD, the International Labor Organization and the United Nations system.

- The U.S. Council opposes many of the changes to current law offered in H.R. 3838 on the grounds that they will seriously impair the ability of U.S. enterprises to operate effectively, compete with their foreign competitors, and negatively impact the U.S. balance of payments.

- The U.S. Council supports the retention of the overall foreign tax credit limitation.

- The U.S. Council opposes the proliferation of the separate limitation "baskets" for banking or insurance income, shipping income, and certain foreign currency gains, on conceptual grounds and because such approach will, contrary to the fairness and simplicity themes under which the Bill was spawned, complicate further what is already an intricate compliance system. Such separate baskets will impose a higher effective rate of tax on U.S.-based international operations compared with foreign-based multinationals. Expanded costs of compliance will burden both taxpayers and the Internal Revenue Service. Creating a myriad of other separate basket limitation items serves no policy purpose and would only further compound the already intricate nature of the foreign tax credit provisions.

- The U.S. Council supports the broadening of the existing separate basket for portfolio interest to encompass other types of passive income, provided that such basket includes only income from portfolio type investments. We oppose, however, the exclusion of high tax rate passive income from such a basket solely on the basis that it has borne a high rate of foreign tax. Furthermore, we urge the repeal of the separate basket for Section 907 (oil income).

- The U.S. Council opposes the "look-through" concept in general and particularly its application to non-controlled foreign affiliates, in which case the U.S. shareholder has no power to obtain access to information necessary to comply with this provision.

- The U.S. Council supports the constructive changes to integrate the computation of earnings and profits under Sections 902 and 964, the use of cumulative pools of earnings and profits and taxes for dividend and deemed paid credit purposes, and a ten-year carryforward period for unused foreign tax credits.

- The U.S. Council opposes the adoption of a new foreign tax credit limitation with respect to banks and other financial institutions restricting the amount of a gross withholding tax on crossborder interest flows available for credit to the U.S. tax on the net interest income. Such proposal reflects a lack of understanding of the economics of crossborder lending. Furthermore, it will cause U.S. banks to reject requests for further financing by the developing nations.

- The U.S. Council opposes the changes in the title passage provisions because they do not afford the same certainty and are not based upon the economic reality of passage of risk.

- The U.S. Council supports, as a constructive change, the modifications offered with respect to the sourcing of income arising from the sale and/or licensing of intangible property.

- The U.S. Council opposes the proposed new sourcing concept for transportation income as arbitrary.

- The U.S. Council opposes the elimination of the "80-20" corporation exception to the normal sourcing rules, as inconsistent with the 1984 Act changes, which go in the opposite direction, i.e., tracking U.S. source income through foreign corporations.

- The U.S. Council opposes the significant expansion of the scope of Subpart F as well as the amendment to the definition of a controlled foreign corporation. Without any clear policy explanation, the Bill significantly changes an area of the law that has remained virtually intact since its enactment in 1962. The move is clearly in the unwarranted direction of terminating the deferral from U.S. tax of earnings of controlled foreign subsidiaries. In particular, we are concerned over the immediate impact of these proposals on the banking, insurance and shipping industries. The expansion is objectionable on both policy and practical grounds, as the ability of distinguishing tainted Subpart F income from operating income will become even hazier and the underlying premise that a foreign corporation must be controlled by U.S. shareholders to cause Subpart F income will be lost. Furthermore, moving in the direction of ending deferral is totally out of step with accepted international tax norms. (Our detailed paper discusses the many technical changes that will be operative here to bring about this unwarranted result.)

- The U.S. Council opposes the consolidated methodology of allocating interest to foreign source income as adopted by the Bill. The proposal injects a built-in bias against a multinational's foreign source income and thus has the effect of creating a competitive advantage for foreign-owned multinationals. This anomaly occurs since the borrowing costs of foreign affiliates are ignored in the allocation causing foreign source income to bear, in many cases, a double measure of interest.

- The U.S. Council opposes the lowering of the foreign earned income exclusion and subjecting it to the alternative minimum tax as a regressive, anti-competitive move.

- The U.S. Council opposes the radical modifications impacting the application of Section 482 to the intercompany licensing of intangibles. The measure is completely inconsistent with the traditional statutory concept mandating the use of arm's-length pricing in related party situations. Under the traditional approach, the transfer price should be determined at date of transfer, without upward adjustments for property which might prove to be more valuable than originally envisaged. The opportunity for local country deduction of such after-the-fact adjustments is negligible, leaving a U.S. taxpayer at the mercy of competent authority or perhaps suffering double taxation.

The U.S. Council is pleased to have the opportunity to present its views to the Committee. The more detailed study is available upon request from Cynthia J. Duncan, U.S. Council for International Business, (212) 354-4480.

February 20, 1986

Statement on Behalf of
The Unitary Tax Campaign, Ltd.

This statement is submitted on behalf of the Unitary Tax Campaign, Ltd. ("UTC") for inclusion in the record of the hearings of the Committee on Finance on H.R. 3838 (the "Tax Reform Act of 1985"). The UTC represents over 50 British international companies that have investments in the United States. For the reasons set forth in this statement, we respectfully urge the Committee to approve satisfactory legislation this year to prohibit the use by States of the worldwide unitary method to reach beyond the "water's edge" to tax the non-U.S. income of foreign corporations.

I.

Introduction

A small minority of the fifty States now use the so-called "worldwide unitary method" in an effort to tax income earned by a foreign corporation from sources outside the United States merely because that corporation and its U.S. affiliate are deemed to be engaged in a single, or unitary, business enterprise. This approach to the taxation of foreign source income is not used by the United States or by any of its principal trading partners. It frequently results in the double taxation of such income and is inconsistent with internationally accepted standards of taxation. It has become a source of tension between the United States and many foreign governments.

S. 1974 was prepared by the Department of the Treasury at the specific request of the President as a measured and balanced response to these international tensions and to fulfill the commitment of the United States to seek Congressional action to preclude the continuing use of the worldwide unitary method in the absence of satisfactory action by the several States to abandon this method of taxation. While the proposed legislation would limit the use of the unitary method except for dividing domestic source income among States, it would require (as a matter of Federal law) the reporting to the States of such information as is necessary to assure that income earned by domestic corporations from transactions with their foreign affiliates does not improperly escape State taxation.

Generally speaking, the "water's edge" approach embodied in S. 1974 seeks to fulfill in a responsible and even-handed manner the commitment of President Reagan to develop remedial legislation and seek its enactment. As described more fully below, the UTC has reservations with respect to certain features of the proposed legislation. In the interest of both sound tax policy and harmonious international relations, Congress should enact satisfactory legislation this year.

II.

Description of Worldwide Unitary Method

It is a basic principle of tax policy that when a business enterprise earns income in different jurisdictions, some mechanism must be employed to divide that income fairly among the various jurisdictions so that such income is not taxed more than once. The "separate accounting" theory is the accepted norm in international taxation. It has been adopted by the Organization for Economic Co-Operation and Development (OECD), of which the United States and most of its principal trading partners are members, and is applied by the United States in the exercise of its own taxing jurisdiction.

While many States use some form of the unitary method to divide domestic income among the various States, only a small minority of States (Alaska, California, Idaho, Montana, New Hampshire, North Dakota and Utah) now seek to employ the unitary method to extend their taxing jurisdiction beyond the water's edge. The worldwide unitary method ignores both the existence of separate corporate entities and the source of income and instead attempts to reach beyond the boundries of the United States to tax the total income of the business enterprise. Under the unitary method, the amount of income to be taxed by a State is typically determined through application of a formula which compares the sales, payroll and property within a jurisdiction to total sales, payroll and property and allocates the income of the enterprise in accordance with that ratio.

When the worldwide unitary method is applied by a State to the foreign source income of foreign affiliates, a tax will be imposed on income not earned in, or properly allocable to, that State. Moreover, since governments of the countries in which the foreign affiliate earns its income are not parties to the apportionment system used by this small minority of States and will already have taxed such income, a second tax is effectively imposed when such foreign source income is taxed by a State using the worldwide unitary method.

III.

Worldwide Unitary Taxation Is Inconsistent With the Policies of the United States

The double taxation inherent in the worldwide unitary method (together with the other tax policy deficiencies noted below) is inconsistent with long established practices of the United States on matters of international taxation. In addition, the continued adherence of a small minority of States to the worldwide unitary method, despite requests from the Administration that each such State abandon this method, has resulted in serious and continuing foreign policy concerns for the United States. These concerns have been repeatedly articulated by the Administration. The Secretary of State recently made clear these objections in letters to the Governors of those States which continue to utilize the worldwide unitary method. In part, the Secretary of State said:

> Continued State taxation on a worldwide unitary basis will greatly impair the ability of the Federal government to carry out its tax and investment policy in the international arena and to manage the sensitive issue of international double taxation. The worldwide unitary issue has seriously complicated our economic relations with many of our closest allies. During my tenure as Secretary of State, this has been a difficult and long-lasting issue. The Department of State has received diplomatic

> notes complaining about State use of the worldwide unitary method of taxation from virtually every developed country in the world. The unitary issue has been partially responsible for stalling some bilateral treaty negotiations.

Continued use of the worldwide unitary method by a small minority of States inevitably will force foreign governments to take retalitory action, to the detriment of United States businesses with international operations, even if such action might be perceived as inconsistent with existing treaties. As the President has recognized, remedial Federal legislation is necessary. Congress must act to preserve the international tax policy of the United States and its relationships with foreign governments.

IV.

The Worldwide Unitary Method Violates Sound Principles of Tax Policy

A. Distortion of Income and Double Taxation

As explained above, the use of the worldwide unitary method to reach beyond the water's edge results in double taxation. The unitary method, developed in the first instance by States for use within the functionally integrated economy of the United States, also distorts the measurement of income when applied on a worldwide basis to tax the foreign source income of foreign corporations. The validity of the unitary business theory depends on the assumption that the payroll, property and sales factors produce the same amount of income in each jurisdiction in which a firm operates. This premise is generally true only with respect to United States source income because wage rates, property values and sales prices do not vary greatly within the United States economy.

When the unitary business principle is extended beyond the water's edge to tax foreign source income, however, it produces a distorted result because wage rates, property values and sales prices vary significantly between the United States and most foreign countries. The variances are due to a wide range of factors including differences in cultures, economic development, and degrees of government regulation. As a practical matter, the formula apportionment factors are generally higher in the United States, and therefore the three-factor formula consistently apportions more income to a worldwide unitary State than is actually earned in, or otherwise properly allocable to, that State. To the extent that foreign source income is over-allocated to a State, double taxation necessarily occurs.

B. Arm's Length Standard

By clear contrast, the internationally accepted standard treats each corporate member of the affiliated group which comprises the multinational enterprise as a separate taxpayer. The affiliated members are treated as if they were unrelated separate entities for the purpose of determining income from intercompany transactions. The effectiveness of this approach depends on an efficient means for determining arm's length prices for goods and services transferred from one member to another.

Most national governments have adopted the separate accounting theory for dividing the income of multinational business enterprises. The approach has been accepted by all members of the OECD. Practically, the separate accounting theory eliminates the need for any formula division of income among different taxing jurisdictions because multi-national income is allocated to each member corporation in accordance with its transactions, and generally each member corporation conducts its business in only one country. To prevent tax avoidance through artificial transfer pricing, most national governments have generally agreed to exchange tax information under bilateral tax treaties or separate executive agreements.

Measured against this internationally accepted standard, the worldwide unitary method of State taxation is a wholly deficient means of dividing the income of a multi-national enterprise.

C. Decreases Foreign Investment in the U.S.

New investments in the United States or the expansion of existing plants by United States companies with foreign parents may well be deterred by either the use by a State of the worldwide unitary method or the fear of its adoption in other States.

This negative effect may arise for at least two reasons. First, application of the worldwide unitary method increases the direct cost of investments in the United States. Second, States using the worldwide unitary method have not established any consistent or coherent principles to define "unitary business." Therefore, a potential foreign investor cannot anticipate with any certainty the extent to which income of multinational operations will be included in a State's computations or, consequently, the ultimate tax costs of an investment in the United States. This uncertainty further deters investment.

D. Prohibitive Compliance and Administrative Costs

The worldwide unitary method requires a foreign-based firm with international operations to prepare and maintain records in United States currency and tax accounting terms demanded by the worldwide unitary States. Such reporting is complex, expensive and burdensome since for all other tax purposes the firms are required only to maintain records according to the independent tax accounting rules of the jurisdictions in which they operate.

The required conversion of financial data of each foreign subsidiary to United States dollars must take into account many different exchange rates, sharp fluctuations and devaluations. For a foreign-based firm with extensive international operations, such a task is an unbearable administrative burden. Computing tax liability under the varied tax accounting standards of the worldwide unitary States requires separate and new sets of calculations for each State and further complicates compliance with the State laws. In many cases, the costs of compliance with these administrative provisions may exceed the tax which is ultimately due to the State.

Often, a United States subsidiary of a foreign-based firm with international operations does not have access to information of its related foreign corporations. Stringent secrecy provisions designed to protect confidential financial information may prohibit divulgence of financial information located within a foreign jurisdiction. It is clear that States have no enforcement jurisdiction which overrides such foreign laws, yet worldwide combined reporting requires the production of such privileged information.

V.

SUGGESTED CHANGES TO S. 1974

While UTC supports legislation to prohibit the use of the worldwide unitary method, and urges the enactment of satisfactory legislation this year, S. 1974 contains several provisions which should be modified.

A. Imposition of Worldwide Unitary Taxation Should Not Be a Penalty for Noncompliance

The provisions of S. 1974 establish two conditions to the general prohibition on use of the worldwide unitary method. Specifically, a state would still be able to impose the worldwide unitary method if: (1) a taxpayer "materially fails" to comply with the new Federal information reporting requirement or with "the legal or procedural requirements" of State income tax laws; or (2) neither the taxpayer nor the government of the "relevant foreign country" provides "material" information to a State after "proper request."

The establishment of any conditions is improper. The prohibition of the worldwide unitary method should not be treated as a privilege. The worldwide unitary method violates basic principles of taxation and is contrary to the policies of the United States. To sanction use of the worldwide unitary combination for any reason, including as a penalty for noncompliance with information requirements, is improper. Rather, the legislation should penalize noncompliance by the imposition of separate penalties. Such penalties are open and direct sanctions for noncompliance and are the usual manner in which the United States enforces the information return requirements of its own tax laws.

In this connection, it should be noted the UTC does not oppose the inclusion in the legislation of reporting requirements based upon the concepts of the domestic disclosure spreadsheet contained in Principle III of the Worldwide Unitary Taxation Working Group. However, these information requirements should function independently of the prohibition on the worldwide unitary method. In addition, the reporting requirements should be drafted with a greater degree of precision to enable firms to comply with the requirements in good faith and without uncertainty. This is, good faith compliance should be subject to precise and reasonable determinations. Similarly, S. 1974 should be amended to specify the procedure under which a "proper request" for information may be made to a foreign government. In general, UTC believes that States should obtain information only from the United States government to the extent permitted by any tax treaty or executive agreement to which the United States is a party.

B. The Threshhold Should Be Changed

The proposed legislation contains provisions to define foreign corporations which are within the "water's edge" and thus subject to unitary taxation. In general, the proposed legislation provides a two-pronged requirement for the nexus required to be within the water's edge. Specifically, a foreign corporation must either: (1) have at least $10 million in compensation payments, sales or purchases, or property assignable to United States locations; or (2) have at least 20 percent (an average of percentages) of its total compensation payments, sales and property assignable to United States locations.

The UTC has consistently taken the position that the proposed legislation should adhere to the principles the United States espouses in the double taxation agreements into which it has entered. Thus, the water's edge definition should be based upon the concept of a "permanent establishment." If, however, threshholds of the type embodied in S. 1974 are retained, the dollar figure should be raised so as to avoid creating substantial compliance costs for companies whose tax would at best be minimal.

C. The Branch Provision Should Be Expanded

The proposed legislation provides that a United States bank branch of a foreign corporation may be treated as a separate United States corporation. This provision recognizes that banks generally may not incorporate subsidiaries and prevents the treatment of all of the foreign corporation's income as within the water's edge merely because the bank branch is located in the United States.

The provision, however, should not be limited only to branches of foreign-based banks. Other situations exist where a multinational enterprise may be required to operate through a single multinational company with a large number of branches. Such a case should qualify for treatment similar to that provided for foreign-based banks in the proposed legislation.

D. Other Modifications

The UTC is now preparing and will shortly submit a series of technical suggestions with respect to S. 1974.

We would welcome the opportunity to work with the Committee and its staff to resolve these technical issues and otherwise to assist in the expeditious consideration of this urgently needed legislation.

Respectfully submitted,

PATTON, BOGGS & BLOW

Thomas H. Boggs, Jr.
Donald V. Moorehead

BISHOP, LIBERMAN, COOK,
PURCELL & REYNOLDS

Marlow W. Cook

A-K ASSOCIATES, INC.

Nicholai Konovaloff

THE UNIVERSITY OF ALABAMA

OFFICE OF THE PRESIDENT

February 18, 1986

TO: Senate Finance Committee

I am gravely concerned as an educator, a university president, and as a citizen about the proposed undercutting of the nationwide pension system for higher education. The vesting, funding, portability, and annuity guarantees, features that have long been recognized as the best in pension principles, are clearly endangered by proposals to remove from TIAA-CREF its long-standing federal tax exemption.

I subscribe to the notion, advanced in the Carnegie Foundation study entitled "Higher Education and the American Resurgence," that this country's ability to compete and to lead is dependent on the nature and quality of higher education. A talented and dedicated faculty is essential to high-quality educational and research programs. We must continue to attract and retain highly qualified and able faculty to college teaching. A good pension system, which is contractually guaranteed, immediately vested in the individual, fully funded, and portable among institutions has contributed greatly to enhancing the desirability of a career in college teaching and research.

203 ROSE ADMINISTRATION BUILDING · (205) 348-5100 · P.O. BOX B, UNIVERSITY, ALABAMA 35486-1498

I hope that irreparable damage will not be done and that the integrity of the TIAA-CREF pension plan will be preserved. I feel certain that you will closely examine this proposed taxation measure and contemplate the far-reaching effects of weakening this pension plan.

Sincerely,

Joab L. Thomas

Joab L. Thomas

President

JLT/dm

cc: Senator Howell Heflin
    Senator Jeremiah Denton
    Congressman Richard Shelby

Post Office Box BT
University, Alabama 35486
Telephone (205) 348-5121

The
University
of Alabama
System

The University of Alabama, University
The University of Alabama in Birmingham
The University of Alabama in Huntsville

February 18, 1986

Senate Finance Committee
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Sirs:

My purpose is to urge you to oppose the provisions of H.R. 3838 that would allow the taxation of the TIAA-CREF pension system. If enacted, section 1012 of the bill would have severe negative effects on pension plans provided throughout the educational community. I urge you to consider the following facts:

1) TIAA-CREF is the nationwide, fully-funded, fully-vested, portable pension system for 3,600 U.S. colleges, universities, independent schools and related nonprofit educational organizations. It holds the retirement funds for approximately one million current and retired employees of these nonprofit educational organizations.

2) TIAA, in 1920, and CREF, in 1953, were exempted by the Internal Revenue Service from Federal income taxes because they are organized and

Equal Opportunity in Education and Employment

Senate Finance Committee
Page Two
February 18, 1986

operated exclusively for educational purposes. For more than 65 years, participating institutions have relied on the tax-exempt status of the TIAA-CREF system when depositing their retirement funds.

3) TIAA-CREF's nationwide pension system operates as a unique multi-employer pension fund and is very different from a commercial insurance company. TIAA-CREF serves only nonprofit educational organizations and is itself a nonprofit organization. All of TIAA-CREF's assets support pension and related benefits for higher education, and by charter and trust law cannot be diverted for any other purpose.

Section 1012 of H.R. 3838 would terminate the long-standing tax exemption of the TIAA-CREF pension system, while continuing tax exemption for virtually all other pension funds. This would treat higher education's pension system unfairly and have a devastating impact on participants' pension benefits. That is why I urge the Committee to oppose the provisions and support the continuation of the tax exempt status of the TIAA-CREF pension system. Please give this your serious attention. I trust you will agree that the provisions in question should be eliminated.

Sincerely,

Thomas A. Bartlett

Thomas A. Bartlett

TAB:sr

UAB
The University of Alabama in Birmingham
Office of the President
205/934-3493

February 17, 1986

Committee on Finance
United States Senate
Washington, D.C.

Gentlemen:

On behalf of the University of Alabama at Birmingham, I wish to join in support of the testimony presented to the Committee on February 4, 1986, by James G. MacDonald, Chairman and Chief Executive Officer of the Teachers' Insurance and Annuity Association. As noted by Mr. MacDonald, the provision in HR 3838 to terminate TIAA/CREF's tax exemption would adversely affect the retirement programs of our faculty and staff. Accordingly, I urge you to continue the long-standing tax exemption of the TIAA/CREF pension system.

I would also note, however, other provisions of HR 3838 would have even more serious consequences for college and university retirement plans than would a change in TIAA's tax status. In particular, the proposed application of so-called "non-discrimination rules" to 403(b) annuities would disrupt a workable, effective system which has evolved over many years, and we are strongly opposed to this unnecessary provision.

Sincerely,

S. Richardson Hill, Jr., M.D.
President

SRHjr/dbb

cc: The Honorable Jeremiah Denton
The Honorable Howell Heflin

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The University of Dayton

February 14, 1986

Senate Finance Committee
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Ladies and Gentlemen:

On behalf of the Faculty and Staff of the University of Dayton, I wish to call to your attention several provisions in The Tax Reform Act of 1985 (HR-3838), as passed by the House of Representatives, which would react adversely on them.

One of the provisions would withdraw the tax exemption of the Teachers Insurance and Annuity Association (TIAA-CREF) upon which our employees are dependent for a portion of their retirement income. The University has been a member of this program for over 30 years and it has enabled us to supplement Social Security benefits which were never intended to provide sufficient retirement income.

The removal of the tax exemption accorded to the TIAA-CREF program would reduce retirement income for all members of the plan. It also is unfair since virtually all other pension plans, including those of labor unions, corporations, government agencies, etc., are not taxed.

A second provision in the Tax Reform Act would reduce the maximum allowable contribution by salary reduction to a basic retirement plan to $7,000

OFFICE OF THE PRESIDENT
300 College Park Dayton, Ohio 45469-0001

annually, including IRA contributions. This limitation also appears grossly unfair since it reacts unfavorably on an individual's extra effort to provide adequate retirement income.

A third provision of the House bill would adversely affect many of our employees who have been setting aside extra retirement savings in (cashable) elective tax-deferred annuities. In addition to reducing maximum contributions to these annuities, the House also places strict limitations on when and how such annuity benefits can be withdrawn if attributable to contributions made after January 1, 1986. It also imposes a severe tax penalty on cash withdrawals regardless of whether the amount withdrawn was attributable to contributions made before or after January 1, 1986.

Finally, the Tax Reform Act would impose unnecessary and costly administrative burdens on educational institutions even though it is my understanding that there is no evidence of any significant problem of pension discrimination against lower paid employees.

These provisions are of considerable concern to all of us at the University of Dayton and I request your support for the elimination of the provisions as the Senate prepares its own bill.

Thank you very much for any attention you can give to these matters. Your continued support of higher education is appreciated.

Sincerely,

Raymond L. Fitz

Brother Raymond L. Fitz, S.M.
President

UNIVERSITY
OF HARTFORD

West Hartford, CT 06117
The President
203-243-4417

February 13, 1986

Senate Finance Committee
Room SD-219
Senate Dirksen Office Building
Washington, DC 20510

Attention: Ms. Betty Scott-Boom

Dear Ms. Scott-Boom:

I am advised that the Senate Finance Committee rules indicate that an appropriate way to share one's concern about pending legislation with the Senate Finance Committee is to address a typewritten, double-spaced, letter to you. Pursuant to that requirement, I am writing to say that I have read the testimony of James G. MacDonald, Chairman and Chief Executive Officer of Teachers Insurance and Annuity Association/College Retirement Equities Fund, presented to the Senate Finance Committee on February 4, 1986 during hearings on H.R. 3838, "Proposed Taxation of Pension Plan Funds held by TIAA-CREF."

By this letter I want to associate myself with the arguments made by Mr. MacDonald. I can think of no virtue that accompanies removal of the longstanding federal tax exemption on the pension funds of almost one million active and retired TIAA-CREF participants, and, as Mr. MacDonald pointed out, there seem to be ample vices associated with this initiative. I hope the Committee, in its wisdom, will retain the current TIAA/CREF status.

My thanks in advance for your consideration and for that of your senators.

Sincerely,

Stephen Trachtenberg

Stephen Joel Trachtenberg
President

SJT/emc

University of Notre Dame
Notre Dame, Indiana 46556

Office of the President

Cable Address "Dulac"

February 17, 1986

Senate Finance Committee
c/o Betty Scott-Boom
Committee on Finance, Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Sirs:

I am writing to urge you to continue the longstanding tax-exemption of TIAA-CREF that HR3838 would terminate.

As you know from hearings on this subject, TIAA-CREF operates exclusively for educational and charitable purposes. It serves as a nationwide portable benefit system which currently covers more than 3600 educational institutions, 89% of faculty in all private colleges and universities, and 63% of faculty in all public colleges and universities. TIAA-CREF has approximately one million participants, including about 150,000 retired employees now receiving pension incomes. It is, therefore, a vital system for a large and important group of higher education employees.

Since virtually all pension funds except TIAA-CREF would remain tax exempt, I am disturbed that the termination of TIAA-CREF's status would treat higher education's pension system inequitably and unfairly reduce pension benefits for its participants. This is simply unjust.

Furthermore, the repeal would demand formidable restructuring of the TIAA-CREF system and require substantial changes in the plans of participating institutions. Such action would virtually destroy TIAA-CREF's great value as a nationwide system, impair its portability, reduce faculty mobility, and inflict damage on the system of higher education in the United States.

As president of a university which has been proud of the security we have been able to offer our faculty and staff through TIAA-CREF, I ask you to continue tax exempt status for the TIAA-CREF pension system.

Cordially yours,

(Rev.) Theodore M. Hesburgh, C.S.C.
President

University of Puget Sound

TACOMA WASHINGTON 98416

Philip M. Phibbs
President

February 13, 1986

Senate Finance Committee
Betty Scott-Boom
Committee on Finance
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Senate Finance Committee Members:

As president of the University of Puget Sound and as advisory board member and former president of the National Association of Independent Colleges and Universities, I am writing in opposition to Section 1012 of H.R. 3838. It is my understanding that this section would eliminate tax exemption for the TIAA/CREF pension system.

Since the initial establishment of its retirement plan in 1936, Puget Sound has relied on the tax-exempt status of the TIAA/CREF system when depositing retirement funds on behalf of faculty and staff members. The retroactivity of Section 1012's application to the funds already contributed to TIAA/CREF is, therefore, especially distressing. Secondly, the fact that under H.R. 3838 other pension funds would continue to be tax exempt creates a burden for private higher education that is not only inequitable, but poorly timed. Finally, the resultant reduction in participants' pension benefits would be unfortunate and unfair, both from the individual's and the institution's vantagepoint. The possibility of reductions in retirement benefits comes during a period when we in higher education are attempting to maximize retirement benefits to increase both the options open to faculty members when they reach normal retirement age and the staffing flexibility of institutions.

Therefore, I strongly urge the Committee to continue the long-standing tax exemption of the TIAA/CREF pension system.

Sincerely,

Philip M. Phibbs
President

cc: Daniel J. Evans, U.S.S.
Slade Gorton, U.S.S.
Don Bonker, M.C.
Rod Chandler, M.C.
Norm Dicks, M.C.
Thomas S. Foley, M.C.
Mike Lowry, M.C.
Sid Morrison, M.C.
Joel Pritchard, M.C.
Al Swift, M.C.

The University of Vermont
Burlington, Vermont 05405-0160

February 13, 1986

Senate Finance Committee
United States Senate
Washington, DC 20510

Dear Senators:

I wish to express the strong support of The University of Vermont, its Faculty, and its Staff for continuing the tax-exempt status of the pension plans for TIAA/CREF. Accordingly, we are strongly opposed to Section 1012 of H.R. 3838.

This legislation would directly affect the people who are most important to maintaining the strength of higher education in our nation.

As I understand the proposed legislation, it would necessitate a direct reduction in pension benefits to TIAA retirees. I cannot believe that it is the intent of the Congress to put education at a disadvantage in relationship to other pension plans that would not lose their tax exceptions.

If H.R. 3838 were to pass in its present form, it would adversely affect higher education at a time when many other sources of Federal support are also being threatened or cut back.

I urge that you amend section 1012 of H.R. 3838 accordingly.

Sincerely,

Lattie F. Coor
President

LFC/awh

2-13-08

cc: Robert Stafford
Patrick Leahy
James Jeffords

UNIVERSITY OF VIRGINIA
CHARLOTTESVILLE

OFFICE OF THE PRESIDENT

February 17, 1986

Senate Finance Committee
Attention: Betty Scott-Boom
Committee on Finance
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Members of the Committee:

I write to express deep concern about the proposed change in the tax-exempt status of TIAA-CREF. I do so not only as a university president, but as one who has served for the past seven years as a trustee of the Carnegie Foundation for the Advancement of Teaching, the predecessor of TIAA-CREF (and still a source of pensions for a small number of faculty and surviving spouses whose plans vested before 1931).

The proposed tax liability of TIAA-CREF could do great harm to the academic profession, both in tangible terms and in terms of faculty morale at a critical time in higher education. TIAA-CREF is not simply a retirement program; it is a vital link within the academic community. The current system has provided both a form of assurance and hope for millions of university and college professors and

MADISON HALL BOX 9011 22906-9011 TELEPHONE 804-924-3337

has brought about a flexibility within the profession which is vital to the interests of students as well as faculty.

I would strongly urge that you make no change in the current tax status of TIAA-CREF.

Very sincerely,

Robert M. O'Neil
President

RMO:acr

cc: The Honorable Paul S Trible, Jr.
The Honorable John W. Warner
The Honorable D. French Slaughter, Jr.

UTAH STATE UNIVERSITY · LOGAN, UTAH 84322

OFFICE OF THE PRESIDENT

18 February 1986

Senate Finance Committee
c/o Betty Scott-Boom
Committee on Finance
Senate Dirksen Office Building, Room SD-219
Washington, D.C. 20510

Dear Chairman and Members of the Committee:

I am writing to petition the continuance of the tax exemption for the TIAA/CREF Pension System. This exemption would be terminated under Section 1012 of H.R. 3838. TIAA/CREF has approximately one million participants who are employees of educational institutions; and at Utah State University, over one thousand employees belong to this system. For them, it is their primary pension system. Since it is well established under national pension policy that pensions should not be taxed at the plan level but taxed as income when received, it appears that this benefit will be lost in House Resolution 3838.

The effect of this taxation would carry negative income implications to our employees who participate in the plan. The proposed taxation under H.R. 3838 would directly reduce the pension benefit payable to TIAA/CREF retirees. The retention of quality staff in higher education is critical, and benefits play a major role in that retention. A reduction in the retirement benefit could negatively affect the retention of quality staff.

Our administrative staff members have carefully reviewed the testimony given before your committee on 4 February 1986, by James G. MacDonald, Chairman and Chief Executive Officer of TIAA/CREF, and we concur with the arguments put forth by Mr. MacDonald. I would urge your committee to continue the long-standing tax exemption of TIAA/CREF that H.R. 3838 would eliminate.

Sincerely,

Stanford Cazier
President

SC/jm

cc: Senator E. J. "Jake" Garn
Senator Orrin G. Hatch
Evan N. Stevenson, Vice President for Business, Utah State University
Clark M. England, Director of Personnel, Utah State University
Ward O'Neill, TIAA/CREF

WABASH COLLEGE
CRAWFORDSVILLE, INDIANA 47933
OFFICE OF THE PRESIDENT

February 15, 1986

Senate Finance Committee
Room SD-219
Senate Dirksen Office Building
Washington, D.C. 20510

Dear Sirs:

Having reviewed the proposed changes in taxation of TIAA-CREF retirement funds, my impression is that those who drafted the proposal may not understand either the purpose or the operation of college retirement plans. To approach TIAA's contingency reserve as if it were part of an ordinary insurance option is to misunderstand both its purpose and application. I encourage your committee not to disturb the tax exempt status of TIAA-CREF.

Yours sincerely,

Lewis S. Salter

LSS/md

cc: Senator Richard Lugar
Senator Daniel Quayle

WEBER STATE COLLEGE

STEPHEN D. NADAULD, Ph.D.
PRESIDENT

MILLER ADMINISTRATION BLDG
OGDEN, UTAH 84408-1001
801-626-6001

February 14, 1986

Senate Finance Committee:

On behalf of the 685 faculty and administrative employees at Weber State College who participate in the TIAA/CREF pension system, I wish to express concern over the provisions of Section 1012 of H.R. 3838. The bill would discontinue tax exemption for educators under the TIAA/CREF plan while allowing continued tax exemption for most other pension funds.

The change is certainly unfair and presents a barrier to adequate retirement funding for academic employees. In most cases, their less-than-competitive salaries simply do not provide the means for them to replace the lost retirement funds with supplementary retirement programs. I do not think that it was the intent of the committee to create this dilemma for higher education, and I would urge you to continue the fair practice of TIAA-CREF tax exemption.

Cordially,

Stephen D. Nadauld

Stephen D. Nadauld
President

jw